No. 9242

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

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West Coast Life Insurance Company (a corporation), Pacific National Bank of San Francisco (a national banking association), et al.,

Appellants,

vs.

Merced Irrigation District ~~and Reconstruction Finance Corporation~~,

Appellees.

BRIEF FOR APPELLANTS.

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BRIEF FOR APPELLANTS.

STATEMENT REGARDING JURISDICTION.

The District Court.

This proceeding was commenced by the filing of a petition (R. 8) for composition of debts under the provisions of Chapter 9 of the Bankruptcy Act of 1898 as amended (11 U. S. C. §§401-404), said petition being filed by Merced Irrigation District, an irrigation district organized under the provisions of "the California Irrigation District Act" of the State of California, approved March 31, 1897, and acts amendatory thereof. Appellants, holders of bonds of said district, appeared and filed their claims, answers and objections to the proposed plan. (R. 107.)

The Circuit Court of Appeals.

After a hearing of said petition the District Court entered a decree on February 21, 1939, pursuant to Section 83 of the Bankruptcy Act as amended, which decree confirmed the plan of composition proposed by said district. Notice of entry of said decree was mailed on February 28, 1939. Motion for a new trial was made by appellants on March 20, 1939 (R. 266), which was denied by the Court on March 28, 1939. (R. 267.) Appellants filed notice of appeal on March 29, 1939 (R. 268), copies of which notice were mailed to appellees by the Clerk of the Court on March 30, 1939. (R. 273.) On March 30, 1939 (R. 268), appellants filed a petition for an order allowing appeal (R. 274), with assignments of errors (R. 281), and on said day the Court made its order allowing the appeal (R. 280), and on said day the citation on appeal was made (R. 4), which citation was served on Merced Irrigation District on April 5, 1939 (R. 6), and on Reconstruction Finance Corporation on April 25, 1939. (R. 7.) The jurisdiction of this Court to entertain said appeal is the following: Sections 24, 25 and 83 of said Bankruptcy Act.

STATEMENT OF THE CASE.

The Merced Irrigation District is an irrigation district organized in 1919 under the provisions of the California Irrigation District Act, having a gross area of over 189,000 acres, and is situated in the County of Merced, in the Southern District of California, occupying the main portion of Merced County south of the Merced River and east of the San Joaquin River. It is the fifth largest irrigation district in the State. There are three incorporated cities within the boundaries of the district, the principal one of which is Merced, with a population of close to 10,000.

Prior to the organization of the district, irrigation was scattered over an area of more than 100,000 acres, although all of that area was not receiving water. The Crocker-Huffman Canal irrigated a maximum of 40,000 acres, and there was a large number of private pumping plants.

The Engineer's report in January, 1921, called for a total expenditure, with complete development, of $15,850,000. The estimated capitalized value of the energy to be produced at the power house was $6,932,000, leaving an estimated average net irrigation costs against lands in the district of $46.93 per acre. Under the plan the Crocker-Huffman system was purchased at a cost of $2,250,000; Exchequer Dam was built at a cost of $4,448,000 and the power plant at $2,000,000. Funds were allocated to improve and extend the distribution system and complete the drainage system and for the relocation of the Yosemite Valley railroad to take it out of the proposed Exchequer Reservoir site. Three small drainage districts were taken over, and their bonds assumed by petitioner. Agreements were made with respect to water rights for land along Merced River. Agreements were also made with holders of water rights under the Crocker-Huffman system. Neither the Crocker-Huffman contracts nor the bonds against the drainage districts were included in the composition plan and they are to be paid out in full. (R. 514.) When the work was done the bonded debt of the district came to $16,250,000. A more detailed history of the district will be found at page 118 of Respondents Exhibit OO.

Exhibit OO is the transcript of record in the Supreme Court of the United States, on the present petitioner's petition for certiorari in the prior proceeding brought to enforce the plan of composition here in question. Four printed copies of Exhibit OO are on file with the Court in the present record.

The bond issues of the district embraced within the composition proceeding consist of three issues of bonds aggregating $16,190,000 in principal amount, consisting of a first issue of $11,940,000 dated January 1, 1922, due serially from 1934 to 1962, bearing interest, part at 5½% and part at 6%; a second issue of bonds dated May 1, 1924, in the principal amount of $3,250,000 bearing interest at 6%, due serially from 1937 to 1964, and a third issue of bonds dated April 1, 1926, bearing interest at 5½% due serially from 1965 to 1966. (R. 10.)

The interest is represented by coupons payable to bearer and due semi-anually. These coupons and the matured bonds bear interest at 7% per annum under the provisions of Section 52 of the California Irrigation District Act when presented for payment and unpaid.

The Merced Irrigation District made all payments according to the maturities of its bond issues including principal and interest up to and including the payment due January 1, 1933. It defaulted on the July 1, 1933, payment.

At about this time an action was commenced in the Third District Court of Appeal in the State of California, entitled *Bates v. McHenry,* an action for writ of mandate against the treasurer of the district to require payment in the order of presentation under Section 52 of the California Irrigation District Act. The decision of this case appears at 123 Cal. App. 81, 10 Pac. (2d) 1038, and held that although the bond fund was then insufficient to pay all claimants in full payment must be made in the order of presentation until the fund was exhausted. This judgment is final.

Assuming that all bonds and coupons which have matured, commencing with July 1, 1933, under the foregoing bond issues, are outstanding and unpaid, the total amount of principal matured as of November 1, 1938, was $386,000

and the total amount of principal and interest claimed by petitioner to be past due was $6,468,072. (R. 669.) As we later show, this is an overstatement of the amount past due by more than one million dollars, even assuming that all of the bonds held by the R. F. C. are payable in full with interest.

One of the vital facts in the case is that long prior to the filing of the petition herein, and in fact prior to the enactment of the statute under which this proceeding was filed (Secs. 81-84 of the Bankruptcy Act), over 90% of the entire bonded debt had been surrendered by the bondholders for 51.501 cents on the dollar, the necessary funds having been loaned to the district by the R. F. C. Appellants rely strongly on the contention (a) that the petitioner's total indebtedness was thus reduced by more than $7,100,000 plus all overdue interest on the bonds taken up with funds lent by the R. F. C. (b) Since all this occurred long prior to the enactment of the statute in question, it obviously was not done with a view to the present proceeding or pursuant to the statute at all; and (c) it was therefore improper for the district to contend and for the court below to hold that the fairness of the plan should be determined on the theory that the district still owed the entire amount of principal ($14,686,000).

In March, 1932, a committee of representatives of the Houses that underwrote the Merced bonds joined with another association called the California Irrigation and Reclamation District Bondholders Association to form a committee (R. 495), and thereafter functioned as a Bondholders' Committee, of which B. P. Lester was Secretary. The Committee solicited the deposit of bonds under a deposit agreement dated March 1, 1932 (R. 576), and a major portion of the bonds, including those of many of appellants here, were deposited with the Committee. As

a result of various studies and negotiations a refunding program was submitted by the Board of Directors to the people of the district. This refunding program was voted upon favorably by the electors on November 22, 1933, and provided for payment in full of the bond principal of the district with an extension of maturities and some reduction in interest. (Ex OO, p. 91.)

After the enactment of Section 36 of the Emergency Farm Mortgage Act providing for loans by the R. F. C. to irrigation districts to reduce their debts, an application was made on December 16, 1933 (R. 600) by the district to the R. F. C. (The Reconstruction Finance Corporation is referred to throughout these proceedings as the R. F. C.)

The R. F. C. on November 14, 1934, granted a loan of $8,600,000 (Ex. OO, p. 155), and the offer of this loan was accepted by the district by a resolution dated December 11, 1934. (Ex. OO, p. 180.) This loan was calculated to pay 51.501 cents on the dollar of bond principal, with nothing for accrued interest and was word for word identical with the plan now sought to be enforced. (Ex. OO, p. 180.) This proposal was submitted to the California Districts Securities Commission which, by its Order No. 54 on February 15, 1935 (R. 949), approved the issuance of the refunding bonds and the making of the contract therefor. Thereupon the proposal was submitted to the electors who on March 20, 1935, voted in favor thereof. (R. 603.) The Bank of America owned over $3,000,000 of the bonds, principal amount. (R. 885, 504, 508.) This bank was extensively involved in the district directly because of large ownership of lands and mortgages. (R. 472, 473, 503.) The Bondholders' Committee at this time represented over 80% of the bondholders and desiring to learn the wishes of the bondholders on January 7, 1935, submitted to them a questionnaire (R.

958) calling for a vote by the bondholders as to whether they desired (1) the cash settlement (i. e., 51¢ in cash) or (2) the former refunding plan. No other alternative was submitted to them. In the questionnaire the Committee members stated that they considered the cash offer "unduly low". The bondholders (63% of the total) indicated their preference for the cash offer plan. The Committee thereupon, acting upon and in accordance with this vote, voted by a majority of 8 to 5 in favor of the plan (R. 501) which provided for liquidation of the bondholders' holdings on the basis stated. Certain large bondholders were individually represented on the Bondholders' Committee. Of these, James Irvine, the Bekins estates, West Coast Life Insurance Company, Charles D. Bates and former Governor James N. Gillett withdrew their bonds and have consistently opposed the Cash Offer Plan. The only large bondholder represented on the Committee which did not withdraw was the Bank of America. (R. 885, 504.)

Arrangements were made to carry out this plan and on October 4, 1935 (the Bankruptcy statute under which this proceeding is brought was passed in 1937), over $14,000,000 (i. e., over 86%) of bonded indebtedness of the foregoing bond issues was deposited and surrendered and the owners thereof received their $515.01 per bond. (R. 344.) It is contended by the district that the R. F. C. owns these bonds at their full face value and is entitled to vote them. This is one of the principal issues in the case. The district contends that the arrangement between the R. F. C. and the district resulted in the relationship of vendor and vendee, and appellants contend that it resulted in the relationship of debtor and creditor, the interest of the R. F. C. being at most that of a pledgee.

After the enactment of the first Municipal Bankruptcy Act, on May 24, 1934, the Merced Irrigation District, on April 19, 1935 (Ex. OO, p. 41), filed a petition in bank-

ruptcy in the District Court setting forth a plan identical with the Cash Offer Plan and the plan of composition involved in this proceeding. Substantially all the appellants here appeared there and contested the issues setting up substantially the same objections as are here urged.

The Bondholders' Committee filed a consent to the plan on behalf of the bondholders who had voted to accept the Cash Offer Plan, and a few scattered individuals also filed consent to the plan. Authority was given by the depositors under the Cash Offer Plan to consent to a proceeding under Section 80 of the Bankruptcy Act (the former statute). (R. 584, 593, where the Cash Offer Plan is set forth.)

After a trial on the merits, the District Court on March 4, 1936, rendered its decree confirming the plan. An appeal was thereupon taken to this Court where the cause was reversed, with directions to dismiss, on April 12, 1937 (R. 107), as reported in 89 Fed. (2d) 1002. By this time the *Ashton* case had been decided in the United States Supreme Court, but nevertheless the Merced Irrigation District applied to the United States Supreme Court for a writ of certiorari which was denied by that Court on October 11, 1937, 58 Sup. Ct. 30.

The decree of dismissal entered pursuant to the mandate in the former cause (R. 964) on July 6, 1937, was in terms unqualified.

The plea of *res adjudicata* was raised by the appellants in this case and is one of the principal issues.

During the pendency of said proceedings in the Supreme Court, the Merced Irrigation District nevertheless, on July 20, 1937 (R. 809), filed a petition in the Superior Court of Merced County under the provisions of California Statutes 1937, Chapter 4, for confirmation of the same plan of composition. In this case the R. F. C. filed

a purported consent dated July 9, 1937. (R. 823.) This case likewise went to trial and it was contested by substantially the same objectors. After that cause was submitted to the judge he rendered an opinion on October 5, 1937 (R. 970), in favor of the Merced Irrigation District and ordered the preparation of findings and a decree in accordance with his opinion. No findings, however, were ever presented by the district. The pendency of those proceedings is raised in bar of these proceedings.

The present proceedings were inaugurated by the filing of a petition in the lower Court on June 17, 1938 (R. 8), whereupon the appellants appeared by answer, filed claims, and set up their defenses. The cause went to trial before Hon. Paul J. McCormick in November, 1938. The hearing was upon the isues raised including a controversy as to whether the R. F. C. was a creditor affected by the plan. This latter issue was raised by motion, of which due notice had been given to the R. F. C. (R. 139, 145, 341.) The R. F. C. failed, however, to appear. It likewise failed to file any claim in these proceedings; and its consent (R. 644) does not directly allege ownership by it of the bonds. On January 10, 1939, the District Judge rendered his opinion which is reported at 25 Fed. Supp. 981. (R. 168.) Thereafter an interlocutory decree was presented and objections to the findings and decree were made. (R. 196, 204.) These were disallowed and the decree signed February 21, 1939. (R. 220.) Thereafter appellants made a motion for a new trial, which it is their contention should have been granted. (R. 239, 267.) After the denial of this motion this appeal was taken. (R. 273, 268, 4.)

Section 83 does not excuse the failure of the R. F. C. to file its claim, even if the claim should be regarded as a loan secured by a pledge of bonds. If, as we contend, the R. F. C. was required to file its claim, it was plainly error to enforce the plan of composition.

FIRST PROPOSITION: THE RECONSTRUCTION FINANCE CORPORATION IS NOT A CREDITOR AFFECTED BY THE PLAN OF COMPOSITION AND ITS CONSENT IS NOT ENTITLED TO BE CONSIDERED.

Assignments of error:

"20. The court erred in finding and holding that the Reconstruction Finance Corporation is a creditor affected by the plan."

"21. The court erred in finding and holding that the Reconstruction Finance Corporation is the owner or holder of the original bond issues of the Merced Irrigation District entitled to vote on the plan of composition herein." (R. 285.)

"30. The court erred in finding that said plan was not prepared or substantially completed or executed several years before the commencement of this proceeding, and in finding that said plan is a plan of composition pursuant to said Chapter IX." (R. 286.)

By Section 83 of the Bankruptcy Act the petition must allege that not less than 51 per centum in amount of the securities *affected by the plan* (excluding however any such securities owned, held or controlled by the petitioner) have accepted it in writing. By the same section it is provided that not less than ten days prior to the time fixed for the hearing any creditor of the petitioner *affected by the plan* may file an answer.

By the same section (subdivision b) it is provided the plan of composition shall not be confirmed until it has been accepted in writing by or on behalf of creditors holding at least two-thirds of the aggregate amount of claims of all classes *affected by the plan.*

In subdivision (a) of the same section it is provided that "No creditor shall be deemed to be affected by any plan of composition unless the same shall *affect his interest materially,* * * *".

In Section 82 it is provided that the term "security affected by the plan" means security as to which the rights of the holders are proposed to be adjusted or modified materially by the consummation of the composition agreement.

The term "affected by the plan" of course means adversely affected by the plan.

The real question is whether or not Reconstruction Finance Corporation made a loan to the district. If it did, then the bonds which it holds are either effectively retired or are collateral to the loan, and the district's obligation is the amount of the loan, and the obligation owing to the R. F. C. is not affected by the plan of composition. In other words, the question is, what is the obligation of the district to the R. F. C.? If it is an obligation according to the terms of the deposited bonds, the district does not owe the R. F. C. anything on a loan. If there is a loan, the district has no obligation on the bonds except to the extent that they might possibly be enforced as security in liquidating the loan.

As counsel for petitioner reiterated in the Court below (R. 361, 385), the relationship is determined by the actual contracts in evidence, though respondents go a step further and say that the true nature of the contracts is also demonstrated by the conduct of the parties thereto.

The operative documents making up the contract with the R. F. C. are:

1. Resolution of the R. F. C. granting a loan, dated November 14, 1934. (Ex. OO, p. 155.)

2. Acceptance of the loan by the district, on December 11, 1934. (Ex. OO, p. 180.)

3. Resolution of petitioner adopting refunding plan. (Ex. OO, p. 183.)

4. Agreement between R. F. C. and the district. (Ex. OO, p. 217.)

5. Refunding bond purchase contract. (Ex. OO, p. 202.)

6. Proposition voted on by electors of district. (R. 603.)

7. Order No. 54 of California Districts Securities Commission. (R. 949.)

8. Deposit Agreement of original bondholders. (R. 576.)

We now show that these documents demonstrate that the Reconstruction Finance Corporation granted the district a loan secured by bonds surrendered to R. F. C. Taking up the documents in order, we find:

1. The resolution of the R. F. C. granting a loan stated that the district had "applied to this Corporation for a loan to enable it to reduce and refinance its outstanding indebtedness, pursuant to the provisions of Section 36, Part 4, of the Emergency Farm Mortgage Act of 1933, as amended", and that the Reconstruction Finance Corporation had appraised the district, determined that it was economically sound, and therefore

> "authorized a loan to or for the benefit of the Borrower of not exceeding $8,600,000.00 plus 4% interest."

The district paid the R. F. C. $750 for the appraisal. (R. 547.) The resolution further provided that the loan should be evidenced by 4% "New Bonds" equal in amount to the loan, *but if the district should, before delivery of the new bonds, repay the advancements to the Reconstruction Finance Corporation, with 4% interest, the obligation would be terminated.* (p. 165 of Ex. OO.)

The resolution also provided that the district should levy taxes "proportional to the reduction in the corresponding annual requirements for principal and interest

of the outstanding indebtedness'' and should make reports and keep its affairs acceptable to the R. F. C.

This resolution provided that disbursement should be made only if all outstanding bonds were deposited, but this was later amended to provide that disbursement would be made upon deposit of 85% of the bonds. (Pet. Exs. 4 and 5.)

It can hardly be said that the foregoing resolution means anything but that the R. F. C. granted a loan to the district.

The second document of interest is the resolution of the directors of the district adopted December 11, 1934 (p. 180 of Ex. OO), by which the district accepted the loan:

> ''this resolution shall constitute an agreement by the Borrower with Reconstruction Finance Corporation whereby the Borrower accepts the benefits of such loan.''

The third paper is the resolution of the directors of the district adopting a refunding plan for issuance of new bonds in the sum of $8,600,000 to evidence the loan granted by the R. F. C. upon application of the district. (p. 183 of Ex. OO.)

The fourth paper is an agreement between the R. F. C. and the district, dated August 14, 1935. (p. 217 of Ex. OO.) It recited that

> ''the District represents that over 85 per cent of its outstanding indebtedness is now available for refinancing on the basis provided for in the Resolution authorizing the loan;''

and provided that during the time the Reconstruction Finance Corporation holds any of the old securities and the same have not been refinanced by delivery of new bonds, the district will anually levy and pay to the Reconstruction Finance Corporation

> "four per cent upon the total amount of the disbursements made to or for the benefit of the District in acquiring such Old Securities."

The fifth document in the chain (p. 202 of Ex. OO) dated September 16, 1935, is an agreement that the district will issue and the R. F. C. will purchase not more than $8,600,000 of refunding bonds, and that

> "R. F. C. shall be under no obligation to purchase refunding bonds beyond the amount necessary, in its judgment for refunding the indebtedness owed to creditors of the Borrower who join in the plan of refinancing, contemplated by a resolution of R. F. C., authorizing this loan and adopted November 14, 1934. In the event any of the refunding bonds are sold to purchasers other than R. F. C., the principal amount of bonds which R. F. C. is obligated to purchase shall be correspondingly reduced." (Ex. OO, pp. 205, 206.)

Paragraph 6 of the contract provides for payment of interest and for a reserve fund for payment of refunding bonds, and paragraph 7 provides for the allocation of power revenues to payment of the refunding bonds.

The sixth document is the proposition on which the electors of the district voted. (R. 603.) This was a proposal to issue refunding bonds to repay the advances to be made by the R. F. C. In other words the authority of the directors of the district to make a contract was limited to the issuance of refunding bonds to repay the R. F. C. loan. (California Irrigation District Act, secs. 30c, 30e, 31, 32a.)

Furthermore, Sections 3 to 9 of the California Districts Securities Commission Act provided for the certification by that Commission of the new bonds as legal investment for trust funds and banks and for a determination that the bond issue did not exceed 60% of the security for the bonds. (Cal. Stats. 1931, p. 2263.)

Order No. 54 (R. 949) of the Commission (the seventh document) is such authorization. It limits the district's authority to the issuance of refunding bonds (Sec. 3) "to repay the Reconstruction Finance Corporation for equal amounts of loans provided by said corporation for the payment of the district's present outstanding bonds. * * *"

In handling the old bonds and the loan to the district, the R. F. C. wrote a letter of instructions (R. 557) to the Federal Reserve Bank at San Francisco directing the latter to pay to respective "depositaries" 51.501 cents per dollar principal for bonds of the district. The letter further directed the Federal Reserve Bank to semi-annually present interest coupons to the district "in face amount as nearly as possible equal to, but in no event less than interest at four per centum (4%) per annum upon the aggregate amount disbursed pursuant to this letter. The amount collected on account of such coupons should exactly equal the amount of such interest".

This instruction was later changed. The bonds were registered, after removal of all coupons, and the district was billed for interest on the R. F. C. loan as such. (R. 353, 354.) No coupons were ever presented by or on behalf of the R. F. C. (R. 353.)

The bonds, according to the letter, were to be accompanied by "Memorandums of Sale and Receipt" executed by each respective depository, the latter documents stating:

> "The undersigned proposes to distribute the proceeds of this sale to the creditors of the above District, who have deposited securities with the undersigned, in amounts and manner as contemplated by the resolution of Reconstruction Finance Corporation authorizing a loan to said District, * * *." (R. 572 and 573.)

The original bondholders deposited their bonds by following the instructions given in a letter dated February

15, 1935 (Petitioner's Exhibit 13, R. 586) from the Bondholders' Committee to the bondholders stating that deposits of bonds by those wishing to accept the "Cash Offer Plan" should be made with certain depositaries, and that the bonds already with the Committee and not withdrawn would be deemed to have accepted the plan.

The eighth document, "Letter of Transmittal and Acceptance of Cash Offer Plan" (R. 584), used by the original bondholders in depositing their bonds with the depositaries, stated:

> "Such bonds are delivered to you as Depositary and are deposited subject to and for the use and purpose stated in the Cash Offer Plan dated February 1, 1935, adopted by Merced Irrigation District Bondholders' Protective Committee."

Analyzing the foregoing papers, it is plain that the R. F. C. agreed to loan *the district* $8,600,000 to reduce the latter's bonded indebtedness. This was indeed all the R. F. C. could do under Title 43, Sec. 403 U. S. C. It was agreed between the R. F. C. and the district that the money should be paid out to bondholders upon deposit of their bonds when at least 85% of outstanding bonds had been deposited. The district may repay the loan in either of two ways. It may either (a) deliver its refunding bonds as evidence of the loan and the old bonds are to be cancelled, or (b) tender the amount of the R. F. C. loan in cash (obtained by sale of the refunding bonds to investors, or obtained in any other way), in which event the old bonds are to be cancelled. Until the payment or the delivery of refunding bonds, the district's only obligation is to pay 4% interest upon the moneys advanced by the R. F. C.

In no way, therefore, is the R. F. C. affected by the plan, whether "materially" or otherwise. It loans its money and gets equal amounts of refunding bonds or re-

payment in cash. That is the beginning and end of the transaction for the Reconstruction Finance Corporation.

If it can be said at all that the R. F. C. holds the old bonds as unretired obligations, such holding cannot be more than as collateral to the loan. The deposited bonds are thus spoken of in some of the papers in evidence and in some of the testimony:

> "Those bonds were delivered to the Reconstruction Finance Corporation and are held as collateral on the loan to the District." (Testimony of B. P. Lester, secretary of the Bondholders' Committee, R. 499.)
> "the pledging of Deposited Securities to this Corporation." (p. 176 of Ex. OO.)

A letter from the Reconstruction Finance Corporation to the district, dated March 8, 1938, stated:

> "The records in this office indicate that *we hold as security for our advances* old bonds of the District in a principal amount aggregating $14,681,000.00, while the outstanding obligations still to be refinanced total $1,746,942.62." (R. 792.)

Even when the R. F. C. brought suit against the district on some of these old bonds (doing so at the suggestion of the attorney for the district, R. 386, 388), apparently in an effort to make a showing as holder of the bonds, the district agreed to and did pay the fees of the attorney for the R. F. C. (R. 380.)

The old bonds were never enforced against the district, but rather the obligations enforced were those under the loan arrangement. Taking the agreements of the parties as a whole, it must be found that as to any holder of old bonds after deposit and payment therefor, the beneficial interest in the bonds rested in the Merced Irrigation District. If the R. F. C. did undertake to enforce the old bonds according to their terms, it could do so solely as trustee for the district since it has asumed a fiduciary

obligation and relationship to the district, whether as pledgee or trustee.

Apart from the papers mentioned, there are other papers and actions which demonstrate conclusively that the Reconstruction Finance Corporation is not a creditor affected by the plan of composition and entitled to vote thereon, among which are the following:

1. **The papers in evidence uniformly speak of the transaction as a loan.**

In this connection it should be remembered that it is the relationship *between the Reconstruction Finance Corporation and the district* which determines whether or not the Reconstruction Finance Corporation is a creditor affected by the plan. If *as against the district* it asserts only a loan which is not to be reduced, it is not a creditor affected by the plan.

The papers heretofore quoted from and which form the basis of the matter, all refer to the transaction with the district as a *loan.*

"Negotiations for a loan." (R. 759.)

"The Reconstruction Finance Corporation has authorized a loan to the Merced Irrigation District which will enable the District, conditioned upon an agreement being affected between the District and its bondholders, to pay $515.01 for each $1,000 bond." (R. 761.)

"the loan will expire" (R. 762)

"when the loan was recommitted." (R. 795.)

"they desire to obtain confirmation of the unpaid balance on your loan." (Letter from Reconstruction Finance Corporation, R. 796.)

"should make or grant a loan to said District * * *."

"A loan had been granted." (R. 799.)

"to evidence said loan * * * out of the proceeds of said loan." (R. 818.)

"That such payment be made out of the proceeds of a loan in the sum of Eight Million Three Hundred Thirty-eight Thousand Eleven and 90/100ths Dollars." (R. 821.)

"authorized a loan." (R. 858.)

"a loan for purposes of refinancing * * * authorized a loan." (R. 868.)

"by accepting said loan." (R. 951.)

"refunding bonds be issued to repay the Reconstruction Finance Corporation for equal amounts of loans provided by said Corporation." (R. 952.)

In 1935, the district brought an action in the Superior Court of Merced County, California, for validation of the refunding bonds to be issued. The judgment therein stated that the district on December 16, 1933, had filed an "application for a loan" with the Reconstruction Finance Corporation and on November 14, 1934, the R. F. C. "authorized a loan to or for the benefit of said district of not exceeding $8,600,000". (R. 600.)

"money loaned by the Reconstruction Finance Corporation." (From minutes of directors of the district, R. 378.)

"Your attention is directed to the formal resolution of this corporation authorizing loan to the above district." (Letter from Chief Engineer of R. F. C., R. 374.)

"This Corporation has authorized a loan of not to exceed $8,600,000 for the purpose of enabling Merced Irrigation District of Merced, California, to reduce and refinance its outstanding indebtedness." (Letter of R. F. C. to Federal Reserve Bank, R. 557.)

When the parties themselves have designated the transaction as a loan, it should not be open to question.

2. **The R.F.C. and district have repeatedly acknowledged that the indebtedness of the district to the R.F.C. is the R.F.C. loan, and not the old bonds.**

"Principal Indebtedness Due R.F.C. $7,560,185.69."

(From annual report of district to R. F. C., dated December 31, 1937, R. 774, see also p. 778.)

"Principal Indebtedness Due R.F.C. $7,564,303.77."

(Report of July 15, 1938, R. 785.)

In a letter to the district from the R. F. C., dated July 3, 1937, the following appears:

"Messrs. Haskins & Sells, Certified Public Accountants are now engaged in making an audit of our accounts. In connection therewith, they desire to obtain confirmation of the unpaid balance on your loan as of the close of business December 31, 1936 which according to our records was as follows:

Loan #		Unpaid Balance
#475		$7,487,569.28
475-A		51,501.00
	(in pencil)	7,539,070.28"

(R. 796.)

The books of the Federal Reserve Bank show the debt of the district to be only the amounts actually paid out for the bonds:

"Our bookkeeping system is such that an outstanding debt is shown. —the Merced Irrigation District is charged with the amount of the particular loan and with interest upon that in our ledger and as the several warrants have been paid the interest has been credited." (Testimony of Atkins of the Federal Reserve Bank, R. 355, 356.)

As noted, a letter from the R. F. C. to the district, of March 8, 1938, stated:

"The records in this office indicate that we hold *as security for our advances* old bonds of the District in a principal amount aggregating $14,681,000, while

the outstanding obligations still to be refinanced total $1,746,942.62.'' (R. 792.)

The fact that the Merced Irrigation District submitted to the R. F. C. statements of income and disbursements and balance sheets which showed the amount of the advances made by the R. F. C. as the total amount of the obligation of the district, and which showed no liability whatsoever on the bonds acquired by the R. F. C., which statements were accepted by the R. F. C., show the manner in which the transaction was regarded by both parties, and, in fact, constituted an account stated.

Also, the fact that the books of the R. F. C. show the total obligation of the district to be merely the amount of the advances, and the acknowledgment of the correctness of such statements, likewise show the loan nature of the transaction and constitute an account stated between the parties.

Interest has been paid only on advancements.

Respondents' Exhibit E (R. 764) shows the interest payments made by the district to the R. F. C.:

12-31-35	33545	10- 4-35 to 12-30-35	71,256.72
1- 7-36	33575	12-31-35	7.51
6- 6-36	34029	1- 1-36 to 6-30-36	149,576.48
12-29-36	35288	7- 1-36 to 12-31-36	151,889.71
6- 8-37	36239	1- 1-37 to 6-30-37	149,542.11
11-30-37	37858	7- 1-37 to 12-31-37	152,411.78
6-21-38	38463	1- 1-38 to 6-30-38	150,000.28

These payments represent interest at 4% per annum on the amounts advanced by the R. F. C. for the periods mentioned.

A demand for payment, check and voucher comprised the papers used for each interest payment. The forms used for the December 31, 1936, interest are set out in the transcript at page 755, and those used on other interest paying dates were the same in form.

An example is the demand by R. F. C. dated December 22, 1936, which read:

> "Following is a statement of your indebtedness to the Reconstruction Finance Corporation for * * * interest which * * * will become due and payable on Jan. 1, 1937.
>
> "Interest is computed on the daily balance of the principal beginning with the date the proceeds of the loan were disbursed for the actual number of days on the basis of 365 days to the year." (R. 757.)

Pursuant to this demand, the Board of Directors of the district adopted a resolution in part as follows:

> "Upon motion of Director Wood, seconded by Director Wolfe, all bills presented were approved and * * * warrant No. 35,288 in favor of the Federal Reserve Bank of San Francisco, being for interest on money loaned by the Reconstruction Finance Corporation for the period July 1, 1936 to January 1, 1937, in the sum of $151,889.71 was ordered paid out of the refunding bond interest fund." (R. 378.)

Mr. Atkins, of the Federal Reserve Bank, testified:

> "No coupons have ever been presented but a short time prior to each semi-annual interest date we sent down a notice of interest due." (R. 353.)
>
> "RFC has not demanded payment of us of any interest coupons on the old bonds at any time." (Testimony of Neel, R. 373.)

The fact that no coupons were presented indicates, of course, that the interest payments were not on the old bonds but on the *loan,* the only obligation of the district to the R. F. C.

3. **The fact that the district, with its own funds, participated in payments to bondholders and paid refinancing expenses further shows there is no obligation of the district to the Reconstruction Finance Corporation on the deposited bonds.**

Mr. Neel, auditor and treasurer of the district, testified:

> "It is a fact, however, that all of those bondholders who were paid anything on account of their bonds on or prior to October 4, 1935 did receive something in addition to the sum of $515.01 on a $1,000 bond and the additional consideration was paid by Merced Irrigation District pursuant to the old original resolution of November 14, 1934 and the acceptance thereof." (R. 366.)

The amount of such payment was $168,027.31. (R. 368.)

Mr. Neel also testified:

> "In addition to the District's paying this sum of $168,027.31 the District also agreed in the accepting of the resolution of November 14, 1934 that it would pay all of the expenses of effecting the arrangement for the taking up of the bonds at $515.01. The expense was a heavy expense." (R. 369.)

This expense amounted to $120,306.94. (R. 371.)

By these payments the original bonds became securities owned or controlled by the petitioner.

4. **The setting up of reserve funds for the Reconstruction Finance Corporation also shows a loan arrangement.**

> "The District in addition to making provision for the semi-annual interest payment further set apart in a reserve fund a certain amount annually to meet the requirements of the RFC as set forth in the resolution of November 14, 1934 and annually we have placed in a reserve fund beginning with 1936 a certain sum of money. The reserve fund was actually set up in 1936 and $92,200.00 placed in the reserve." (Testimony of Neel, R. 369-370.)

"We have a second refunding bond interest fund in which there was at this time $676,132.34 and that is separate from the reserve fund. We have in the refunding interest account $676,132.34 and in the reserve account $373,860.60." (Testimony of Neel, R. 373.)

The Reconstruction Finance Corporation, if it purports to be an owner of bonds, has received the following valuable preferences:

(1) Interest on its advances;

(2) A pledge of a very valuable asset of the district, its power revenue;

(3) Control over the financial affairs of the district;

(4) The right to loan money to the district at 4% interest and the right to buy bonds of the district bearing such interest, payable as provided in the contract, and which, because of the low outstanding debt of the district and the security on such new bonds, can probably be sold at a very substantial profit to the R. F. C.

All of these preferences have put the R. F. C. in an entirely different position from that of appellants.

5. The R.F.C. is not entitled to be recognized as a creditor because it has not filed a claim.

The R. F. C. is not here maintaining that it asserts against the district a claim of some $16,000,000. It has filed no claim of any amount and nothing appears to indicate that it is affected by the plan of composition. Rather, it has merely filed an unverified "consent" to the plan *wholly devoid of any statement of ownership,* and it is the *district* which is claiming it owes the R. F. C. twice the amount of the R. F. C. loan.

Section 83(b) of the Bankruptcy Act provides that upon filing of the petition notice shall be given to creditors and

> "The judge shall prescribe the form of the notice, which shall specify the manner in which claims and interests of creditors shall be filed, or evidenced, on or before the date fixed for the hearing."

Notice of the hearing was given requiring creditors to file their claims, and respondents did so, but there is no claim on behalf of the R. F. C.

The reason for the astonishing fact that the R. F. C. filed no claim in this proceeding is apparent. The fact that in its "consent" the R. F. C. carefully avoided any statement that it owned the bonds (coupled with its failure to file any claim), shows that it was unwilling, in the face of its loan contract, to file a claim as creditor to the amount of the bonds. On the other hand, if it filed a claim for the amount actually owing, it would oust the Court of jurisdiction, by thus showing that it was not a creditor affected by the plan. And since it has not filed a claim, there is nothing before the Court to indicate that any creditor affected by the plan, or even claiming to be affected, has consented to it.

> "No creditor shall be deemed to be affected by any plan of composition unless the same shall affect his interest materially." (Sec. 83(a).)

6. The transaction summarized above resulted in a pledge.

In *Shelley v. Byers,* 73 Cal. App. 44, 238 Pac. 177, the complaint alleged that plaintiff was the owner of and entitled to the possession of certain property, which was denied in the answer. Whether plaintiff was the owner was the prime question in the case. The Court found for the plaintiff and entered judgment, which was reversed on this appeal.

The Shelley boys, who had conducted an army department store, went through bankruptcy.

Thereafter they entered into a contract with Gollober and Rosenberg, upon the face of which there was what purported to be a sale to them by the Shelley boys of certain property, including all of the stock in trade of the store, with a right to repurchase reserved to the Shelley boys.

Appellant's theory of the transaction is that it was a pledge. Respondent contends that the transaction was a sale with an optional right reserved to the vendors to repurchase.

The Court said, page 54:

> "Under our Statute a mortgagee of personal property in possession and a pledgee are practically, if not identically, the same. (Civ. Code, Sec. 2924 and 2987.) *No legal title passes in either case,* but merely the right of possession for the purpose of security. (Civ. Code, Sec. 2888.)"

At page 62:

> "That the parties intended the property to be held by (G. & R.) as security is unmistakably disclosed by certain strongly marked features shown on the face of the writing itself. In the first place, *the transaction had its inception in a negotiation for a loan,* or for what is the equivalent of a loan, to the Shelley boys, even if the latter did not become personally liable therefor. This is one of the principal *indicia* of a pledge." (Cases cited and quoted from.)

The case of *Union Securities Inc. v. Merchants Trust and Savings Company* (Ind.), 185 N. E. 150, 95 A. L. R. 1189, is quite analogous to the case of *Shelley v. Byers,* supra. The facts and the law thereof are amply covered in the headnote thereof as follows:

> "A transaction whereby accounts receivable are assigned to another is, though denominated by the

parties a sale of the accounts, in fact a loan, and the assignee of the accounts is not entitled to a preference out of the assets of the assignor in the possession of a receiver for the amount collected on such accounts by the assignor, where the arrangement was that the assignee should advance 88 per cent of the face value of the accounts assigned, pay over an additional 10 per cent when the accounts should be paid, and keep 2 per cent as its profit, that the assignor should become a surety for the payment of such accounts, and collect them at its own expense, and the assignor, with the assignee's knowledge had mingled the proceeds of collection with other funds in its general bank account, paying 2 per cent a month for such amounts as were due and not remitted to the assignee, and the customers whose accounts were assigned were not notified of that fact."

The issue in that case is identical to the issue to be determined in the instant case, and is well stated, page 1193:

> "The decisive question in this case is whether the transaction between appellant and the Retherford Manufacturing Company was a bona fide sale of accounts as claimed by appellant, or was the transaction in fact a loan and the accounts assigned as security?"

The Court then proceeds to define a sale and a loan quoting from Cyc.

Although the contract on its face purported to use words of purchase and sale, the Court held it to be a loan.

The Court therein also discussed the facts and quoted from the case of *In re American Fibre Reed Co.,* 260 Fed. 309, 318. There, too, the corporation sold the accounts to the petitioner, which were collected by the vendors at their expense, the proceeds to be applied first to the payment of the amount advanced by the vendee to the

vendors, and the remainder of the amounts collected went to the vendors for their own benefit. The amount paid by the vendee was about 75 per cent of the face amount of the accounts, and accounts so sold were stamped on the books of the vendors as sold to the petitioner. The Court held:

> "Insofar as the contracts in question here used words fit for a contract of purchase, they are mere shams and devices to cover loans of money at usurious rates of interest."

The Court also cited and quoted from the similar case of *Chase & Baker Co. v. National Trust and Credit Co.*, 215 F. 633, 638. Passing on the question whether the agreement to buy accounts was in fact an agreement of sale or loan, the Court said:

> "A court of equity will not be frustrated in ascertaining the real intention of the parties to make a usurious loan by the fact that parol proof thereof would contradict the written evidence of the apparent transaction."

In another similar case, *In re Grand Union Co.*, 219 Fed. 353, 359, the Court said:

> "Stripped of the verbiage with which the parties have sought to clothe their transaction, the naked facts disclose that what they are doing was not a sale, but a loan, and that the leases were turned over simply by way of security. The Grand Union Company needed money and the Hamilton Company advanced it."

The test is stated as follows, page 1195:

> "The test which determines whether the real transaction between the parties was a loan or a sale is the intention of the parties and their intention is to be ascertained from the whole transaction, including the conduct of the parties as well as their written agreement. The facts as disclosed by the finding show that the real intention of the parties was to effect a loan at a rate of interest not otherwise collectible."

In re Grand Union Co., 219 Fed. 353, certiorari denied in 238 U. S. 626, and appeal dismissed in 238 U. S. 647, the corporation transferred to a credit company certain leases of personal property owned by it. The credit company claimed to have purchased the same under a contract at various discounts according to the maturity of the leases. The Court pointed out that while it will ordinarily assume, where the parties in a written contract call a transaction a sale, that they have used the term correctly and in its technical sense, yet, if the contract goes on to set out in detail the facts of the transaction which merely disclose that what the parties call a sale is in reality not a sale but a loan or bailment or mortgage, the Court must decide according to the real nature of the transaction, without regard to the terms the parties apply to it.

In the case of *In re Rogers,* 20 Fed. Sup. 120, at page 129, there is a discussion as to what a pledge is, the principal point being that one of the elements of a pledge is the sole right of the party to require the payment of the sum for which the pledge was granted.

A debtor's note cannot be treated as collateral security for his own debt.

In the case of *Jones v. Third National Bank of Sedalia,* 13 Fed. (2d) 86, the debtor was indebted to the bank. Part of the debt was secured by Chattel Mortgages. The bank became apprehensive and the debtor gave a new note and chattel mortgage for any debts that are now owing or might be owing in the future. The first debt was paid, but the second note was retained for security for a new loan of $2400, for which the debtor gave a note reciting that the $5000 note was collateral. A further loan of $250 was made, but this note contained no recital of security. The bank filed its claim for the balance due on the $2400 and $250 notes and contended that its claim was a secured one by virtue of the $5000 note. The Court said:

> "Collateral security has been defined as some security additional to the personal obligations of the borrower."

Stating that collateral security necessarily implies the transfer to the creditor of an interest in some property, or lien on property, or obligation, and stated that *a debtor's additional promises to pay cannot be treated as collateral security for his debt, unless such additional promises are themselves secured by a lien on property, or by the obligations of third persons.*

In the case of *Union National Bank v. Peoples' Savings and Trust Co.,* 28 Fed. (2d) 326, the Union Bank loaned $17,500 to the Jersey Cereal Food Company, which gave its judgment notes therefor. Being unable to pay, it gave its gold notes aggregating $19,000 to the bank as further evidence of the original loan. A receiver was appointed. The District Court allowed only the part of the claim based on the $17,500 notes and this was affirmed on appeal. The Court said:

> "when insolvency occurs, he (the creditor) must share pro rata with all the other creditors upon the basis of his real debt regardless of whether he holds one note or two."

An additional promise of a debtor to pay money cannot, from the very nature of the case, be treated as collateral security for his own debt.

Dibert v. D'Arcy, 248 Mo. 617 at 643, 154 S. W. 1116;

In re Waddell-Entz Co., 67 Conn. 324 at 334, 35 Atl. 257,

and the note which is security will be void.

Where personal property is transferred by a debtor to a creditor, the presumption is that the transfer is made as collateral security for the debt.

Borland v. Nevada Bank of San Francisco, 99 Cal. 89.

In *Commercial Security Co. v. Holcombe,* 262 F. 657, the Court said:

> "The nature of a transaction is determined not by the name given to it by the parties, but by its operation and effect. That a transfer of paper evidencing indebtedness payable after the date of the transfer, and which does not include any interest, is not a sale, is quite obvious, when the transferer is required to pay to the transferee interest on the amount owing on such paper before anything is payable by maker, and the transferer has the right to reacquire the paper by paying to the transferee the sum it calls for the interest thereon."

7. The Reconstruction Finance Corporation had no authority in law to do other than make a loan to the district, and the district was authorized only to accept a loan.

The R. F. C.'s only authority to participate in refinancing programs of agencies like petitioner is contained in Section 36 of the Emergency Farm Mortgage Act. (Title 43, Sec. 403, U. S. C.) That statute calls for an "application" for a loan, requires that the purpose thereof be to "reduce and refinance its (the district's) outstanding indebtedness"; and before the loan agreement is made the R. F. C. must be satisfied that an agreement has been made between the "applicant and the holders of the outstanding bonds—under which the applicant will be able to purchase or refund all or a *major part of* such bonds at the price agreed".

The Court is referred further to the language of said Act which provides:

> "Such loan shall be subject to the same terms and conditions as loans made under Section 605 of Title 15 * * *."

This is the R. F. C. Act itself. This latter Act has been construed as *limiting the power of the Corporation to the making of loans;* and there is nothing in the Emer-

gency Farm Mortgage Act which would increase that power.

In *R. F. C. v. Central Republic Trust Company,* 17 F. Supp. 263, the Court said (p. 292):

> "There is no intimation of the intent (by Congress) to use the words 'loans', 'notes', and 'obligations' in any other than their usually accepted meaning."

The Court said (p. 293):

> "Plaintiff corporation (R. F. C.) was created and expressly authorized to make contracts for *loans,* and to sue and to be sued with reference thereto."

In the case of *Baltimore National Bank v. State Tax Commission,* 297 U. S. 209, 80 L. Ed. 850, 56 S. Ct. 417, in a decision written by Mr. Justice Cardozo, the Court discussing the capacity of the Reconstruction Finance Corporation said:

> "Until then there was no power on the part of the Reconstruction Finance Corporation to subscribe for such shares or indeed for any others."

In the case of *Continental National Bank v. Chicago, Rock Island & Pacific Ry. Co.,* 294 U. S. 648, 79 L. Ed. 1110, 55 S. Ct. 595, the Court said:

> "The Reconstruction Finance Corporation Act creates a corporation and vests it with designated powers. Its entire stock is subscribed by the Government but it is none the less a corporation limited by its charter and by the general law."

The R. F. C. was similarly incorporated for a public purpose, and not for private profit.

We also call to the Court's attention the California Act to authorize irrigation districts to cooperate and contract with the United States Government. (Stats. 1917, p. 243.) Section 11 thereof was amended (Stats. 1933, p. 2394) to provide:

"In addition to other powers in this act conferred, irrigation districts shall have authority to *borrow or procure* money from the United States or any agency thereof, for the purpose of *financing or refinancing* of the obligations of the district or the *funding* or *refunding* or *purchase* of the bonds of the district, or for any of the other purposes of the district authorized by the California Irrigation District Act, or acts amendatory thereof or supplemental thereto. As evidence of such *loan or loans* and the obligations of such district to repay the same to the United States or any agency thereof, any irrigation district, * * * may make and enter into contract or contracts with the United States or any agency thereof, as a condition or requirement to the making of such *loan or loans.* Such district may issue bonds of such district as may be required by the contract last above provided for or without such contract, containing such terms and conditions and payable in such manner and from such source or sources of income and/or revenue as may be agreed upon between * * * (them) * * * and may obligate and bind the district for the payment of such bonds according to the terms thereof. * * *."

By no stretch of the imagination can this Act be interpreted as authorizing the district to enter into any other form of contract than one of a loan to the district. It states in terms (Sec. 9) that it does not add any powers except as provided. See *Meyerfeld v. South San Joaquin Irr. Dist.,* 3 Cal. (2d) 409.

This act gives no authority to the district to deal in its own bonds, except to retire them with *loans,* and the contracts with the R. F. C. must be construed in the light of the district's authority.

We believe the foregoing definitely shows the R. F. C. to be merely a lender and not a creditor which can in good faith, or at all, give any acceptance to the plan of composition which can be here considered. The R. F. C. is

not entitled to more than its loan—at any time the district may liquidate its entire debt to the R. F. C. by paying off its loan rather than the face value of deposited securities. Such cannot be done with the appellants and this immediately demonstrates that the R. F. C. is in an entirely different class from appellants.

From the time of the R. F. C. disbursement, it has been getting interest and has by contract tied up the district's assets as security for its loan. The difference of treatment between the R. F. C. and appellants is enough to determine that they are in entirely different classes and the purported consent of one has no bearing on the other.

Unless it be determined that the obligation to the R. F. C. is merely that of a loan, most of the documentary evidence in this case is meaningless, and, in fact, the "Cash Offer Plan" itself was an empty gesture.

In the absence of a claim by the R. F. C., and in view of the loan agreements with the district, and in view of the fact that the district's obligation is directly measured by the statement that:

> "* * * if the Borrower shall, before any New Bonds are delivered to this Corporation, pay or cause to be paid to this Corporation an amount equal to the disbursements it has made to or for the benefit of the Borrower with 4% interest thereon until paid, this Corporation will thereupon surrender or cause to be surrendered the Old Securities then held by it or on its behalf to the Borrower." (Ex. OO, p. 165.)

it appears conclusively that the Reconstruction Finance Corporation is not a creditor affected by the proposed plan of composition, and is not entitled to vote on it as against appellants.

8. No provision in the statute permits debts that have been extinguished to be treated as still existing for any purpose.

We have just shown, we submit, that the facts and relevant rules of law call for the conclusion that the debt of petitioner to R. F. C. is the amount of the R. F. C. loan and no more.

We now observe that no provision in the statute permits debts that have been extinguished to be treated as still existing for any purpose. For lack of space we refer on this point to the brief filed herein by Brobeck, Phleger & Harrison as attorneys for Florence Moore, et al. In that brief (under a heading identical with the heading next above) the above proposition is shown to be sound, primarily for two reasons:

(1) No provision in the Municipal Bankruptcy Act can be rationally construed as intended to provide that a district which, long before the enactment of the bankruptcy act in question, had reduced its indebtedness to a point well within its means, may nevertheless further reduce its debts on the theory that in two years before the bankruptcy statute in question was passed, its debts exceeded its ability to pay.

(2) The only provision which could possibly be argued as intended to have this effect is in any event inapplicable under the rule against retrospective interpretation.

9. The plan has been fully executed out of Court as to the deposited securities.

Disbursements have been made to cover all claims the original consenting bondholders could have on their bonds. They have surrendered their bonds, taken their money, and have gone their way. They are not parties in this proceeding nor could they be, for their deal has been fully consummated.

Neither the R. F. C. nor the district can now withdraw from the loans which have been committed and accepted. All of the rights of the original bondholders of the R. F. C. and of the district, to the extent of the deposited bonds and loan (on which time limits have expired) have become fixed and vested, and the transaction fully executed. It cannot therefore be contended that only for the purposes of this proceeding the status of the parties should be considered as it was five years ago, before disbursement was made.

In the case of *In re West Palm Beach,* 96 Fed. (2d) 85, the Court had before it a situation where the city had before passage of Section 83 carried out a plan to the extent of exchanging the securities involved, leaving, however, a minority of original bonds outstanding. The city sought, after Section 83 was enacted, to compel the minority bondholders to accept the plan.

The Court said:

> "In bankruptcy matters composition has a special meaning, to-wit, a settlement or adjustment which is enforced by the court on all creditors after its acceptance by a required majority. A proposed adjustment out of court is not a plan of composition, but it may become one by being presented to the court."
>
> "* * * the plan with its acceptance became incapable of presentation as a composition because it has been largely executed."
>
> "The owners of these were no longer acceptors of an executory plan, but had been fully settled with under it and had no longer had any direct interest in it. They could not fairly be counted as voters before the court on the propriety of the plan. Of course they would wish the nonacceptors to be forced to scale their debts as they themselves had done. They could no longer have an open mind as to whether, in the light of developments, the plan was a good one or a bad one."

10. The R.F.C. and the district are bound by proceedings in the State Court.

The district in 1937 filed its proceeding under Cal. Stats. 1937, Ch. 24, to refinance its indebtedness, offering the identical plan proposed in this proceeding, with the same creditors involved. The R. F. C. filed its acceptance of the plan in that proceeding. (R. 820.) It and the district are therefore bound by those proceedings and Section 19 of said chapter, which provides:

> "Consent of Accepting Bond or Warrant Holders Not Affected by Invalidity of any Portion of this Act or Dismissal of Petition. In the event that said petition for liquidation, refinancing or readjustment is dismissed, or that any of the provisions hereof for confirmation of the plan or acquisition of the bonds or warrants of the nonaccepting holders shall be declared invalid, such dismissal or declaration shall not affect the effectiveness of the plan with respect to the district or holders of bonds or warrants accepting the same."

In other words the acceptance of the plan proposed in the State Court proceeding which was identical with the plan here proposed (R. 809), was, under the terms of the State statute, an unconditional and irrevocable agreement by the R. F. C. to accept refunding bonds equal in amount to the amount of their loan to the district. Quite apart, therefore, from the numerous other considerations above discussed, the acceptance filed by the R. F. C. in the State proceeding makes it impossible for the district to maintain either that the R. F. C. is now a creditor affected by the plan in the present proceeding or that it is a creditor of the district beyond the amount of its loan.

SECOND PROPOSITION: PETITIONER IS BARRED FROM OBTAINING CONFIRMATION OF ITS PROPOSED PLAN OF COMPOSITION BY REASON OF ITS LACK OF GOOD FAITH AND CONSTRUCTIVE FRAUD.

Assignment of Error No. 12 reads:

"The offer of the plan and its acceptance are not in good faith". (R. 284.)

(See also assignments 68; R. 294; and 113, R. 306.)

1. If a petitioner seeking relief under the Bankruptcy Act comes into Court with unclean hands, or is guilty of any unfairness or lack of good faith, such petitioner is barred from relief regardless of the merits of the plan of composition.

Section 83, Chapter IX, Bankruptcy Act;

Tennessee Pub. Co. v. American Nat. Bank, 299 U. S. 18, 57 S. Ct. 85, 81 L. Ed. 13;

In re Tennessee Pub. Co., (C.C.A., 6) 81 Fed. (2d) 463;

In re Wisun & Golub, Inc., (C.C.A., 2) 84 Fed. (2d) 1;

Sophian v. Congress Realty Co., (C.C.A., 8) 98 F. (2d) 499;

Tellier v. Franks Laundry Co., (C.C.A., 8) 101 Fed. (2d) 561;

In re Barclay Park Corp., (C.C.A., 2) 90 Fed. (2d) 595;

In re Day & Meyer, Murray & Young, Inc., (C.C.A., 2) 93 Fed. (2d) 657;

In re Milwaukee Corporation, (C.C.A., 7) 99 Fed. (2d) 686;

Provident Mutual Life Ins. Co. v. University Evangelical Lutheran Church, (C.C.A., 9) 90 Fed. (2d) 992.

Equitable principles of course govern in bankruptcy.

Bardes v. Hawarden Bk., 178 U. S. 524.

Chapter IX of the Chandler Act, under which this proceeding is brought, after providing, in Section 83a, for the filing of the petition and what it shall contain, has this provision:

> "Upon the filing of such a petition the judge shall enter an order either approving it as properly filed under this chapter, if satisfied that such petition complies with this chapter and *has been filed in good faith, or dismissing it, if not so satisfied.*" (Italics ours.)

In Section 83e of the same chapter it is provided that at the conclusion of the hearing the Court shall make written findings of fact and its conclusions of law, and shall enter an interlocutory decree confirming the plan, if satisfied that

> "(1) It is fair, equitable, and for the best interests of the creditors and does not discriminate unfairly in favor of any creditor or class of creditors; * * * (5) the offer of the plan and its acceptance are in good faith; * * * If not so satisfied, the judge shall enter an order dismissing the proceedings."

While we have not found any cases arising under Chapter IX of the Bankruptcy Act construing these provisions, practically identical provisions in Chapter X, involving corporate reorganizations, and the old Section 77B, have been construed in the cases above cited. For example, Section 141 of Chapter X as to approval or dismissal of the petition when filed is almost identical with the above quoted provision of Chapter IX. Section 221 in Chapter X provides that the judge shall confirm a plan if satisfied, among other things, that

> "(2) the plan is fair and equitable, and feasible; (3) the proposal of the plan and its acceptance are in good faith and have not been made or procured by means of promises forbidden by this Act."

By their terms, some other provisions of the Bankruptcy Act, and particularly Section 29 of the Chandler Act designating offenses under the Bankruptcy Act are applicable to Chapter IX.

Section 29, Subsection f, distinctly provides that the term " 'bankrupt', wherever used in that section, shall include a 'debtor' " by or against whom a petition has been filed proposing an arrangement or plan under this Act.

Reference is here made to Section 29 for a long list of offenses prohibited in cases under the Bankruptcy Act under which this proceeding is brought. Obviously, a violation of any such provisions would constitute such lack of good faith as to require the Court to dismiss the petition.

Thus it has been held that a concealment of assets by a petitioner for corporate reorganization (forbidden by Section 29) would bar any relief under the Act.

In re Wisun & Golub, Inc. (C.C.A., 2) 84 Fed. (2d) 1.

Similarly, efforts to hinder, delay or harass creditors are such a lack of good faith as to bar relief under the Bankruptcy Act.

In re 1688 Milwaukee Corp., (C.C.A., 7) 99 Fed. (2d) 686;

In re Grigsby-Grunow Co., (C.C.A., 7) 77 Fed. (2d) 200;

First Nat. Bank v. Conway Road Estates Co., (C.C.A., 8) 94 Fed. (2d) 736;

Price v. Spokane Silver & Lead Co., (C.C.A., 8) 97 Fed. (2d) 237.

Similarly, the uttering of false statements of financial condition, or making any other false representation, re-

gardless of motive, in a bankruptcy proceeding, is sufficient to bar any relief under the Bankruptcy Act.

In re Wisum & Golub, Inc., (C.C.A., 2) 84 Fed. (2d) 1;
In re Keller, (C.C.A. 2) 86 Fed. (2d) 90;
In re Parsons, (C.C.A. 2) 88 Fed. (2d) 428;
In re Marshall, (C.C.A. 2) 47 Fed. (2d) 209;
In re Slocum, (C.C.A. 2) 22 Fed. (2d) 283;
Shanburg v. Saltzman, (C.C.A. 1) 69 Fed. (2d) 262;
In re Eastham, (D.C., S.D. Tex.) 51 Fed. (2d) 287;
Bankruptcy Act, Sec. 29, Subsec. b, (2).

Similarly, the proposal of a plan of reorganization which results in taking away from the creditors rights and property for the benefit of the debtor, is such bad faith as to prevent confirmation of a plan of reorganization.

Sophian v. Congress Realty Co., (C.C.A. 8) 98 Fed. (2d) 499;
Wayne United Gas Co. v. Owens-Illinois Glass Co., (C.C.A. 4) 91 Fed. (2d) 827:
In re Barclay Park Corp., (C.C.A. 2) 90 Fed. (2d) 595.

2. Petitioner is barred from any relief under Chapter IX of the Bankruptcy Act because it collected $717,932.50 of Trust funds belonging to the bondholders which it intentionally and permanently diverted to its own use.

The undisputed facts as testified to by Mr. Neel, auditor for the petitioner, are as follows:

The last tax levy made for the purpose of paying bonds and interest on bonds by Merced Irrigation District was the levy of 1932-1933. (R. 413.) The collections on the levy made for the year 1932-1933, prior to December 31, 1932, were not sufficient to pay principal and interest maturing

January 1, 1933. (R. 411.) However, there were very heavy collections after that time. The aggregate amount of which exceeded the amount necessary to pay principal and interest due January 1, 1933. After paying bonds and interest maturing January 1, 1933, the district *took out of its bond fund* all moneys levied and collected for the purpose of paying interest and principal of bonds and *used those moneys for general purposes, other than paying the maturity of the principal and interest upon the bonds maturing July 1, 1933, and subsequently.* (R. 412.) In the words of Mr. Neel, as set forth in the Record:

> "When the district made the levy for 1932-1933, it levied in the light of the maturities upon the principal and interest of the bonds which would occur on December 31, 1932, and also on July 1, 1933. Then instead of using the moneys for retiring the bonds maturing July 1, 1933, the district simply *emptied its bond fund* and *kept it empty thereafter,* except for the limited purpose of meeting the maturities of January 1, 1933 and prior thereto." (R. 412.)

Mr. Neel further testified that nothing by way of interest has been paid to any of the dissenting bondholders, beginning with interest due July 1, 1933, for which the said levy of 1932-1933 was made. (R. 423.) In addition to the moneys collected upon the levy made for the year 1932-1933, Mr. Neel testified that after December 31, 1932, there were additional moneys collected upon the levies made for the three years prior to the year 1932-1933, and that these moneys, which came into the district by way of payment upon delinquent levies, were taken by the district and used for general purposes. (R. 413.)

Mr. Neel further testified that the amount due to bondholders on July 1, 1933 was $454,200.00 and that there was collected, applicable to the payment of such sum, the sum of $320,272.93 from the levy for the year 1932-1933. Said amount of $320,272.93 *was placed in the general fund,*

and if it had been placed in the bond fund would have been available for payment of maturities upon those bonds due July 1, 1933. (R. 414.)

Mr. Neel further testified that he had made a computation for the purpose of determining the *total amount that would be in the bond fund today* as the result of the collection of the levy of 1932-1933, after paying maturities of December 31, 1932, and as a result of collecting delinquent taxes that were delinquent as of December 31, 1932 under prior levies, which embraced bond service, and found the total to be $717,932.50, including the $320,272.93 of 1932-1933 collections. (R. 414.)

According to the testimony of Mr. Neel, bonds and interest coupons maturing January 1, 1933 were unpaid and remained unpaid from that date to June 30, 1934. (R. 422.) No payment has ever been made on matured bonds and coupons maturing July 1, 1933 and subsequently. (R. 423.) Petitioner makes no effort to explain or justify its arbitrary action in refusing to apply these bond funds to the payment of the bond obligation for which purpose the money was collected.

Thus, during the period from December 31, 1932, to the time of trial $717,932.50 was diverted from the bond fund to the general purposes of the district, despite the fact that during all of that period large amounts of matured bonds and interest coupons remained unpaid.

Mr. Neel also testified that all of the rentals on land deeded to the district were diverted into the general fund. (R. 415.) Similarly, interest and penalties collected on delinquent assessments, and interest earned on bank deposits were placed in the general fund. (R. 421, 422.)

At the time of the trial, the undisputed evidence was that the petitioner Merced Irrigation District had on deposit in the bank cash in the sum of $1,578,446.00. (R. 669.) Nevertheless, in the face of that fact, counsel for the

petitioner, in answer to the direct question, as to whether it was the intention of the Merced Irrigation District to restore to the bond fund the sums referred to in the examination of Mr. Neel above described, replied that *it was not the intention to restore such funds.* (R. 523.) Furthermore, the testimony of Mr. Neel (R. 412) that "instead of using the moneys which came in as a result of this levy and retiring the maturities of July 1, 1933, *the District simply emptied its bond fund and kept it empty thereafter",* is sufficiently eloquent.

It is, therefore, undisputed that the diversion of the bond funds of the petitioner occurring subsequent to December 31, 1932, by which as was testified, the bond fund was kept empty, *was admittedly wilful and deliberate and remains so to this date.*

The bond fund from which such diversions were made is established by section 67 of the California Irrigation District Act (Stats. 1897, p. 254, as amended; Deering's General Laws, Act 3854), as it read at the time of the issuance of the bonds.

Selby v. Oakdale Irrig. Dist., 140 C. A. 141.

This fund is a trust fund, and must be devoted solely to payment of bond obligations in the manner specified in the Act.

Irrigation District Act, secs. 29, 52;
Bates v. McHenry, 123 C. A. 81;
Provident Land Corp. v. Zumwalt, 12 C. (2d) 378;
El Camino Irrig. Dist. v. El Camino Land Corp., 12 C. (2d) 791;
Carteret County v. Sovereign Courts, 78 F. (2d) 337.

The plan of composition seeks to perpetuate the unlawful act of the District in diverting these funds from the bondholders whose equitable property they are. There is no provision for the repayment thereof, and the plan

contemplates that the District shall keep the funds so appropriated by it, despite the fact that such funds are not the property of the district.

We have seen that the diversion of assets in a reorganization proceeding is such an act of bad faith as will bar any recovery by the petitioner.

Petitioner, having misappropriated trust funds belonging to its bondholders, without intention of restoration, which misappropriation is intended to be perpetuated by the plan of reorganization, is guilty of breach of trust, which is a complete bar to the relief sought by the petitioner herein.

3. The petitioner is barred from relief under the Act because it has unfairly and needlessly harassed, hindered, delayed *and defrauded its creditors.*

(1) We have just discussed the admitted fact that the petitioner, in violation of the rights of respondents, unlawfully diverted over $700,000 of bond funds to other uses. This had the necessary effect (and since it was intentional, the deliberate purpose), of hindering, delaying and defrauding its bondholders, driving down the market price of the bonds, and thereby stampeding bondholders into "accepting" the plan now sought to be enforced (which was first offered early in 1935), and thus creating an atmosphere of plausibility in which to advance the proposition that petitioner could pay only what the plan offers.

(2) Petitioner, in violation of the rights of its bondholders, arbitrarily refused to levy any taxes for the purpose of paying accrued interest and matured bonds of the district for the years 1933, 1934, 1935, 1936, 1937 and 1938. (R. 403.)

During the period from July 1, 1933, to the present time, as testified to by the district auditor, Mr. Neel, the "bond fund has been kept empty" (R. 413.) by diverting

any funds that were properly applicable thereto, and by omitting any levy in the years 1933, 1934, 1935, 1936, 1937 and 1938, for the payment of principal or interest on bonded indebtedness of the district. (R. 403.)

The average assessed value per acre of land within the district is $60.00 per acre, (R. 517) according to the testimony of Mr. Sargent, secretary of the petitioner. On this basis, the owner of an acre of land was entitled to receive four acre feet of water, that is, approximately 1,300,000 gallons of water, in the year 1933, for 60¢. (R. 517.) In the year 1934 when the rate was $1.70 per hundred, the price for the same amount of water was therefore $1.02, and in each of the years 1935, 1936, 1937 and 1938, when the rate was $3.00, the said four acre feet of water cost $1.80, or, according to the testimony of another of the petitioner's witnesses, Mr. Molmberg, averaged about $1.75 (R. 488, 490) for which $1.75 the landowners received the 1,300,000 gallons of water. This rate is cheaper than the rate referred to in the case of *Morris v. Gibson,* 30 Cal. App. (2d) 684, where the District Court of Appeal of the State of California confirmed a referee's finding, at page 690, that the rate of 50¢ per acre foot charged in that district was as low or lower than any rate charged for water in the State of California, whereas the Merced Irrigation District charged only 15¢ per acre foot in 1933, 25¢ in 1934, and 45¢ in each year since that time. This rate compares with the rates in 1929 in Banta-Carbona Irrigation District in San Joaquin County of $4.88 per *acre foot,* in Lindsay-Strathmore District of $21.97 per acre foot, $1.56 per acre foot in South San Joaquin, and $1.27 per acre foot in Turlock (bonds current, not refinanced). (R. 976.)

The result of this low rate has been that the delinquency of the Merced Irrigation District reached the point where, as shown by petitioner's exhibit No. 25 (R. 667) taxes delinquent for the year 1936 and 1937, as of November 1,

1938, were only $3,614.59 on a levy of $342,946.70, the delinquency as of a date sixteen months after the levy became delinquent being fractionally over 1%. The tax delinquency for the three years, 1935, 1936 and 1937, totals about $12,000 (R. 668), as of November 1, 1938, an original levies of over $900,000, an average delinquency for the three years as of November 1 1938, of approximately 1-1/13%.

The delinquency of the 1937-38 levy, as of the delinquent date of the last Monday in June, was 6.84%, a lesser delinquency on the delinquent date than had occurred at any time prior thereto as far back as the table goes (1928).

Hardly any tax district of any kind or character has such a low delinquency as Merced Irrigation District.

We have seen that hindering, delaying and defrauding creditors, is an effective bar to any relief by petitioner herein (supra p. 40).

4. Petitioner is barred from relief by reason of its bad faith in misrepresenting its financial condition to be more than two and one-half million dollars worse than it is in fact, even assuming petitioner's own contention that it owes the R. F. C. the face amount of the old bonds with interest thereon.

A. Petitioner, even on its own theory, falsely overstates its liabilities by at least $1,509,366. This is the sum of several inaccuracies.

(1) Even assuming petitioner's theory concerning its debt to the R. F. C., it overstated the amount of outstanding current liabilities for "Unpaid Matured Bond Interest Coupons" by the sum of $824,684 *which had already been paid* by petitioner to the Reconstruction Finance Corporation, and by the additional sum of $168,-582.00 which *had already been paid* depositing bondholders, on account of such liability.

For the purpose of showing its alleged insolvent condition, petitioner offered the evidence of its auditor that the matured unpaid interest coupons of petitioner totaled $5,194,925, (R. 400) and offered in evidence Exhibit No. 26, labeled "Balance Sheet" (R. 669) which petitioner's auditor testified he prepared (R. 406), and which he testified was a true statement of the financial condition of the petitioner as of November 1, 1938 (R. 425), assuming its original bond liability as outstanding. This balance sheet shows, as a current liability of petitioner, unpaid matured bond interest coupons in the amount of $5,076,185.

On cross-examination, however, petitioner's auditor admitted that over $800,000 ($824,684, R. 764) of interest paid to the Reconstruction Finance Corporation was included in the figure of $5,076,185.00 of matured bond interest coupon liability shown on the balance sheet. (R. 425.) On petitioner's theory that the bonds surrendered to the R. F. C. are actually owing to it, this amount was a payment on the interest coupons held by the R. F. C. (R. 568.) Petitioner's auditor admitted that *nowhere on the balance sheet (Exhibit No. 26)* was any credit shown for this payment to the Reconstruction Finance Corporation. (R. 425.)

Petitioner's auditor further testified that $168,582 was paid as interest to depositing bondholders, and that no effect was given in the balance sheet to that payment. (R. 426.) But here, as with the larger item just discussed, these bonds are still outstanding as the petitioner contends this was a payment on account of matured interest coupons.

Petitioner's auditor further admitted (R. 520) that crediting the interest paid the Reconstruction Finance Corporation and depositing bondholders as payment on matured bond coupons, the liability for matured bond coupons, assuming petitioner's theory as to the debt due

the R. F. C., was $4,082,919, instead of the $5,076,185, shown on the petitioner's balance sheet, Exhibit 26 (R. 520, Exhibit Z, R. 885.)

Thus petitioner, on its own theory, overstated its liability for unpaid matured bond interest coupons by the sum of $993,266.00 *which has been paid.*

(2) Assuming petitioner's own theory of its debt to the R. F. C., it overstated its liability for interest on matured registered coupons by the sum of $129,000, *which never was owed.*

Petitioner's balance sheet, Exhibit No. 26 (R. 669) shows a liability of $1,004,887.54 for accrued interest on registered bonds and coupons.

On cross-examination, petitioner's auditor testified that this item (misprinted $1,400,887.54 at R. 425, 426) included interest at 7% on all coupons on bonds held by Reconstruction Finance Corporation maturing subsequently to January 1, 1933, even though petitioner had paid some of the coupons in question. (R. 425, 426.) The amount of overstatement of the liability for accrued interest on matured coupons thus arising was, on cross-examination, calculated by petitioner's auditor as $129,100.00, making the amount due on this item $875,787.54 instead of $1,004,887.54. (R. 520, Exhibit Z, R. 887.)

(3) Petitioner, in its balance sheet, Exhibit No. 26, overstated its bond principal liability by $387,000.

The bond principal indebtedness of petitioner (assuming that the R. F. C. owns bonds held by it) was and is admittedly $16,190,000. In the balance sheet placed in evidence by petitioner, under the heading "Capital Liabilities—Bond Fund", *the entire amount of the bond issue,* $16,190,000.00 is shown as a liability. *In addition,* under the heading "Current Liabilities—Unpaid Matured Bonds" appears, *as an additional liability,* the sum of

$387,000.00 (R. 669.) The effect of this was to show a total bond liability of $16,578,000, when the true liability was $16,191,000 (Aff. of Stange, R. 247, Aff. of Murphy, R. 252), thus overstating the bond principal liability by $387,000.00 *which the district never did owe.*

The total of the foregoing overstatement of liabilities which the petitioner either *has paid* or *never did owe,* which appear on the balance sheet, which the district introduced to show its alleged insolvent financial condition, is the sum of the foregoing items, to-wit: *$1,509,366.*

B. Petitioner understated its assets by more than $1,000,000.

(1) Petitioner's balance sheet, Exhibit No. 26, does not contain as an asset a levy of approximately $340,000 made for the year 1938-39 (affidavit of Mr. Stange, Item 5, R. 250, 251; Affidavit of Mr. Neel, R. 260), despite the fact that such levy was a lien on the first Monday in March of 1938. (Irrigation District Act, Section 40.) The levy was made in September of 1938 (affidavit of Mr. Sargent, R. 260), the levy was payable on or before November 1, 1938 (Irrigation District Act, Section 41), and became delinquent on the last Monday in December, 1938. (Irrigation District Act, Sec. 41.) Obviously, when the amount of the levy was determined in September of 1938, and a lien already existed in favor of the district upon all the lands within the district for the collection of the levy, it became an asset ascertained in amount immediately, and being due and owing not later than November 1st under the Irrigation District Act, was a current, matured account receivable on November 1st.

(2) There is also omitted from the assets shown on the balance sheet the net value of certain Crocker-Huffman water rights, approximately $840,000.

As testified by Mr. Sargent, Secretary of the District, the District took over the property and water rights in

the Crocker-Huffman Land and Water Company and assumed the obligation of encumbrances against the system, including obligations to deliver water at very low prices to its customers. (R. 510.) Subsequently the rights of said customers to receive water at these low prices were purchased by petitioner, under a contract with the customers providing for the payment of $60,000 a year for seventeen years, or a total of $1,020,000. (R. 512.) Of this sum, $180,000.00 remains unpaid, leaving the net amount paid at $840,000.00. The payments to acquire these rights were, of course, capital expenditures, and this fact was admitted by Mr. Sargent, secretary of petitioner, on cross-examination, to be a capital expenditure. (R. 515.) But the payment for these rights was charged to "Operation and Maintenance" rather than "Capital Expenditure." (R. 515.)

There is no doubt that petitioner's secretary was correct in making this admission. Obviously the price paid the Crocker-Huffman Land and Water Company for its properties was arrived at after deducting an amount sufficient to cover the liability on the customers' contracts thus assumed, from the value of the properties purchased.

In other words, the price paid for the Crocker-Huffman system was the $2,250,000 paid the Crocker-Huffman Land and Water Company, plus the $1,020,000 agreed to be paid its customers for their contracts, totaling $3,270,000, of which $180,000 still remains unpaid. The fact that these contracts are to be paid in full demonstrates the actual value of the asset. (R. 511, 512.) Of this amount, only $2,250,000 is treated as an asset by the petitioner, the rest being admittedly improperly charged to expense.

Thus it appears beyond question that the petitioner has omitted from its statement of assets the $840,000 in question.

(3) The petitioner also has paid annually from $10,000 to $11,000 on the bonds of three Drainage Districts, charging them to "Operation and Maintenance" account instead of "Capital Expenditures." (R. 515.)

These three drainage districts, formed before the irrigation district, were taken over by the district, and their bonds assumed and paid by the district. (R. 514.)

Failure to show the aggregate of these payments as a capital asset was obviously improper for the reasons just discussed. Hence, all of the current tax liability to the District, amounting to approximately $340,000, plus the equity of the District in the Crocker-Huffman contracts in the amount of $840,000, plus the value of the Drainage District Works which the District has taken over, have been omitted from the statement of assets shown on the balance sheet of the petitioner.

C. Even on its own theory, the petitioner overstated the alleged deficit in its bond fund by at least two million dollars.

(1) The petitioner's balance sheet (Exhibit No. 26, R. 669) shows the purported totals of its liabilities for (a) unpaid matured bond interest coupons, (b) unpaid matured bonds, and (c) accrued interest on registered bonds and coupons, and over against the sum of these accounts, states the amount of its cash in the bond interest and principal fund, thus showing a deficit in the bond fund surplus (old) account of $6,466,862.74 (red). (Red not indicated in Record.)

The account termed "bond fund surplus (old)" is so designated to indicate that it relates only to the original $16,190,000 bond issue, and to distinguish it from accounts relating to the refunding loan from the R. F. C.

We have already shown that the unpaid matured bond interest coupon liability is $993,266 *less than* that stated

on the balance sheet. This in fact reduces the bond fund deficit by the same amount, on petitioner's own theory.

Similarly, the fact that the accrued interest on registered bonds and coupons is $129,100 less than that stated on the balance sheet, reduces the bond fund deficit by that further amount.

Similarly, the fact that the unpaid matured bonds in the sum of $387,000 were written up as an additional liability in addition to the entire principal amount of the original bond issue of $16,191,000 reduces the bond fund deficit by that additional amount.

The total of the foregoing deductions that must be made from the bond surplus account deficit as shown by petitioner is *$1,509,366,* all arising from an overstatement of the bond liability, on petitioner's own theory.

(2) In addition to the foregoing errors arising from overstatements of bond liability, $717,932.50 was, as we have seen, admittedly diverted from the bond fund to the general fund.

Since this fund is a trust fund, and the district, as we have seen cannot lawfully remove such funds therefrom, this money, (which is still an asset but held in other funds), is an asset of the bond fund which the district is required to retransfer thereto. *(Selby v. Oakdale Irrig. Dist.)* and accordingly reduces the purported bond deficit by an additional $717,932.50.

On petitioner's own theory, therefore, the aggregate total of the overstatements of bond fund deficit by reason of setting up liabilities that do not exist, in the sum of $1,509,366, and by reason of the diversion of the trust fund of $717,937.50, is *$2,235,869.*

D. The net effect of the foregoing overstatements of liability and understatements of assets is that petitioner overstates its purported total net deficit by more than two and one-half million dollars on its own theory.

(1) The net deficit indicated by petitioner's Exhibit 26 is $2,282,721.21. On the balance sheet which petitioner offers in evidence, Exhibit 26, there is no concise statement of the amount of net worth of the petitioner. The assets are shown, liabilities are shown, but the net worth must be found by adding up the several surplus and capital account figures, and subtracting therefrom the red or deficit surplus account figures. (R. 426, 520.)

The bond surplus (old) account, deficit, printed on the original balance sheet in red (but without an indication in the record that such is the case) of $6,466,862.74, must be offset by the sum of the capital surplus fund, the refunding bond interest surplus, the refunding reserve surplus, and the general fund surplus, aggregating $4,484,-141.53, in order to obtain the net worth of petitioner as shown by the balance sheet. (R. 426 and 520, Exhibit 26, page 669.) The net worth of petitioner thus arrived at is a deficit of $2,282,721.21.

(2) The net deficit of $2,282,721.21, indicated by petitioner's balance sheet, Exhibit No. 26, is in error by the overstatement of the liabilities of the petitioner in the sum of $1,509,366.

Under cross-examination of the District's auditor, he testified (R. 520) that Exhibit "Z" correctly sets forth the *actual* net deficit after correcting the overstatement of bond liability in petitioner's Exhibit 26. (Exhibit "Z", R. 885 and 887.) This shows the capital surplus deficit to be $773,355.21 in place of $2,282,721.21 as indicated by Exhibit 26, arising from the overstatement of bond liability in the sum of $1,509,366.

(3) The net deficit indicated by petitioner's Exhibit 26 is overstated by the amount of assets not set forth on petitioner's balance sheet, in the sum of $1,180,000.

It has been shown that the District entirely omitted from its balance sheet current taxes receivable in the sum of $340,000 as an asset, and that it also omitted the value of the Crocker-Huffman water contracts, the net value of which was $840,000, as well as the value of the Drainage District Works, the exact amount of which is unknown. These assets totaled more than $1,180,000. The assets thus omitted must be added to the capital surplus account as shown on the balance sheet.

The deficit having been reduced to $773,355.21 by omitting the non-existent liabilities, the addition of $1,180,-000 additional assets to the surplus account changes the *net deficit* indicated on petitioner's balance sheet, of *$2,282,721.21,* to a *capital surplus* of at least *$406,644.79.*

(4) Petitioner maintained books and records on two separate theories of its liabilities to the R. F. C., only the one showing the maximum liability being presented to the Court.

Exhibit 26 was presented by petitioner on the theory that, by the advances made by the R. F. C., the R. F. C. became creditor to the full extent of the original bond liability, instead of by the amount of the advances.

At the same time, petitioner submitted reports and *balance sheets* to the R. F. C. semi-annually, showing as the indebtedness of petitioner to R. F. C. only the amount of the latter's advances, amounting to about $7,500,000 (Exhibits J and K, R. 774, 784.) The existence of these reports and balance sheets was discovered by appellant's counsel on an inspection of petitioner's records just prior to trial under court order (R. 143) and they were introduced into evidence by appellants.

Appellants also offered in evidence Exhibits A, (R. 755); E, (R. 764); L, (R. 791); N, (R. 796); among others, showing that the petitioner's own records, and those of the R. F. C., showed the debt from petitioner to R. F. C. to be only the amount of advances made.

Appellants further proved by petitioner's auditor that the books of petitioner were set up allocating funds for the repayment of the loan advances by the R. F. C. (R. 369-370.)

A comparison of the balance sheet of petitioner presented to the Court, Exhibit 26, and the balance sheets presented to the R. F. C., Exhibits J and K, shows that the balance sheet presented to the Court alleges liabilities over $13,000,000 greater than the balance sheets presented to the R. F. C.

The making of erroneous statements as to financial condition bars petitioner from the relief sought in this proceeding.

1. The making or uttering of an untrue balance sheet or financial statement is made unlawful by the Statutes of California, Penal Code, Sections 532a, 563 and 564.

2. The making of a false account in relation to any proceeding under the Bankruptcy Act is prohibited by Section 29, subsection b (paragraph 2) of the Bankruptcy Act.

3. The giving of any false information concerning the financial condition of a petitioner in reorganization proceedings, regardless of motive, is a bar to granting petitioner any relief under the Bankruptcy Act.

In re Wisun & Golub, Inc., 84 Fed. (2d) 1 (C.C.A. 2);

In re Slocum (C.C.A. 2) 22 Fed. (2d) 283;

Shanburg v. Soltzman, 69 Fed. (2d) 262.

In the case of *In re Wisun & Golub* the District Court confirmed a plan of reorganization approved by an overwhelming majority of the creditors, although the referee had found, after an audit of the books and records, that petitioner had not accounted for some six hundred dresses.

The Circuit Court of Appeals reversed the District Court upon the ground that, although the evidence did not show that such failure to account was intentional, the shortage existed and that fact was such an act of bad faith as to bar the petitioner from any relief under the act, the Court saying (p. 3):

> "As a condition preceding approval by the court of a petition as properly filed, it must be found to have been filed in good faith. The master's finding of concealment of the dresses is a *fatal objection* to approval of the petition. A debtor who hides his assets from his creditors and attempts to reorganize its business without disclosure of such assets to his creditors, deals unfairly with them. He attempts to cheat them by withholding property which is theirs for the payment of his indebtedness. To attempt such a fraud is bad faith. 'Equity will not aid those who defraud or deceive.' See In re Knickerbocker Hotel Co., 81 F. (2d) 981 (C.C.A. 7.) Such conduct inspires no confidence and contradicts any avowal of an honest intention to effect a reorganization which should be for the benefit of creditors as much as for the stockholders of the corporation.
>
> The petition should have been refused."

In this case, in place of omitting to account for some six hundred dresses, petitioner omitted to account for a rather substantial amount of assets. Furthermore, petitioner erroneously set up as liabilities a very substantial amount which it never had owed or had paid. Petitioner set up a deficit of a rather substantial amount when in fact petitioner had a surplus. These errors were on the theories most favorable to the petitioner.

It is not necessary to consider the intention of the District in making these errors. The law provides that the making of the errors *ipso facto* constitutes a bar to relief.

It is respectfully submitted that the petitioner is not entitled to relief in this proceeding, by reason of its errors in overstating the amount of its liabilities, and alleged deficit, and understating the amount of its assets.

5. The District's proposal of a plan reducing creditors' claims by half, when all it needs is extension of time, is itself bad faith, under the authorities.

We later show that the district is abundantly able to pay its debts and its need is only for an extension of time owing to temporary absence of funds.

Under the authority of Section 11 of the Districts Securities Commission Act (Appendix p. i) the district has since 1933 levied only such assessments as it has determined, with the Commission's approval that it could pay. (Ex. OO, p. 98.) (R. 711.) Thus the district presently has all the relief it needs.

If as we contend the district has not sustained the burden of proving that it cannot ultimately pay all its debts in full, its attempt to reduce the claims of its creditors by one-half is itself an act of bad faith, under the authorities cited above.

THIRD PROPOSITION: PETITIONER HEREIN IS NOT "INSOLVENT OR UNABLE TO MEET ITS DEBTS AS THEY MATURE".

Assignment of Error No. 14 reads,

> "The Merced Irrigation District, at the time of the filing of its petition was not and is not insolvent, nor unable to pay its debts as they mature." (R. 284.)

Petitioner, apart from a tremendous amount of other assets and revenue, has *cash on hand* sufficient to pay all matured liabilities, and has *power revenue* alone more than sufficient to pay all future obligations as they mature.

As we have shown elsewhere (supra), the liability of the district to the R. F. C. is the amount of the advances made by the R. F. C. to petitioner.

Regardless of the determination of the Court as to whether the R. F. C. is entitled to consent to the plan herein, or to be considered as a creditor of the same class as other bondholders, in considering the question of the solvency of petitioner only *the actual amount which petitioner is required to pay* can be considered as the amount of its liability.

In a bankruptcy proceeding, a creditor who advances money and obtains as security obligations of the debtor greater in amount than the amount of the advances has a claim in bankruptcy only to the extent of the advances.

Jones v. Third National Bank, 13 Fed. (2d) 86;
Union National Bank v. Peoples Trust Co., 28 Fed. (2d) 326.

See also:

Anglo-California Trust Company v. Oakland Railways, 193 Cal. 451 at 466;
Borland v. Nevada Bank of San Francisco, 99 Cal. 89.

The solvency or insolvency of the Merced Irrigation District must be determined as of the date of the filing of the petition herein in May of 1938.

In re Hansen Bakeries, 103 Fed. (2d) 665.

The financial condition of the petitioner arising from the consummation of the contract between the petitioner and the R. F. C. is disclosed in the reports and balance sheets

of the petitioner rendered to the R. F. C. as of December 1, 1937 (Exhibit J, R. 774) and as of July 1, 1938. (Exhibit K, R. 784.)

A reference to said Exhibits J and K and to Exhibit AA (R. 887), a condensed statement bringing these balance sheets to the date of the trial (R. 524), shows a surplus of assets over liabilities of well over $10,000,000. All obligations to the R. F. C. and to all other creditors save appellants are current. There is owing to outstanding bondholders matured interest coupons as of July 1, 1938 in the sum of $496,542.50 and interest on registered bonds and coupons in the sum of $70,459 (R. 788, note on balance sheet), making total interest due $567,001.50. In addition, a part of the matured bonds of the district, which total $387,000 (R. 669), most of which matured bonds are held by R. F. C., is held by outstanding bondholders. The total past due liability to outstanding bondholders is not over $650,000. Cash on hand amounted to $1,578,446.14. (R. 887.)

Thus, after paying all matured obligations from cash on hand, petitioner would still have $800,000 cash on hand.

As we have pointed out elsewhere in this brief (infra) the petitioner's *power revenue* alone is more than sufficient to pay principal and interest maturities on the remainder of its debt.

FOURTH PROPOSITION: THE PLAN OF COMPOSITION IS NOT FAIR, EQUITABLE OR FOR THE BEST INTERESTS OF THE CREDITORS, AND IT IS DISCRIMINATORY.

Assignment of Error No. 9 reads:

> "The plan of composition herein is unfair, inequitable, and unjust and is not for the best interests of the creditors and it discriminates unfairly in favor of the Reconstruction Finance Corporation." (R. 284.)

We will discuss this point entirely on the assumption that the petitioner owes to the R. F. C. the entire principal amount of its bonds, with accrued interest, as it claims.

A. The plan of composition is discriminatory in the following respects:

(1) Assuming that the R. F. C. is a creditor of the same standing as the appellants, the plan is unfair because it offers a 4% bond to the R. F. C., but denies a like privilege to the appellants;

(2) The plan discriminates in favor of the R. F. C. as a creditor because it has allowed to it interest at 4% per annum on the basic figure of 51.501¢ on the dollar ever since October 4, 1935. The district has actually paid to the R. F. C. up to and including July 1, 1939 interest payments in the sum of $1,127,485. (R. 402.) Appellants are not offered any interest whatever.

(3) The plan is discriminatory because it allowed to bondholders who deposited their bonds on or before October 4, 1935, 4% interest from date of deposit to that date. The amount so paid to them by the district was $168,027.31. (R. 763.) No compensation is allowed by the plan to appellants for the period they have waited, although during most of this time there was no statute in effect under which this district could have compelled acceptance of its plan.

In the case of *In re James Irrigation District,* 25 Fed. Supp. 974 at 975, it was held that interest paid to consenting creditors should also be paid to non-consenting creditors.

Appellants should not be penalized for resisting the prior proceeding, which was determined to be void as they contended. Delayed payment is vitally different from prompt payment:

State v. City of New Orleans, 102 U. S. 203.

The plan in that case was approved subject to such provision being made.

(4) The plan is unfair because it permits the payment in full of bonds of other taxing agencies which are in effect liens against the same territory without requiring any corresponding reduction. (R. 955, 957, 959.) In fact, these overlapping bonds have all been paid in full as to all maturities (R. 540), and 5% bonds of one of them at least, the Merced Union High School District, are selling at 101. (R. 521.)

(5) The plan is unfair because it violates the principle of the *Boyd* case, cited elsewhere in this brief, in that it in effect takes property from the bondholder and gives it to a junior encumbrancer, the holder of mortgages and deeds of trust, and to the stockholder, so to speak, viz., the landowner. (*Tellier v. Franks Ldry. Co.,* 101 Fed. (2d) 561.)

B. The plan is unfair, inequitable and not for best interests of creditors.

A plan must give to creditors everything of value to which he is entitled, and can not take from him for the benefit of junior lien-holders or debtors any valuable right or property.

(1) The plan is unfair because it takes *trust funds and properties* belonging to the appellants from them as elsewhere in this brief more particularly shown;

(2) Based on the report of Dr. Benedict (Petitioner's Ex. 35), and a study of computations from the books of the district, it has been determined that as of the year 1936 when the computation was made, the capital loss to the appellants on their investment is 53.3%, by which the landowner would benefit only to the extent of 7.4% on his yearly operating costs. (R. 548, 974.) This means that the senior creditor must give up over 53% of

his investment in order to benefit the landowner to the extent of 7.4% on his yearly operating costs. This contribution is inequitable, and the slight margin of saving of 7.4% on the operating costs of the farmer in the district cannot well be the decisive factor in making his project a paying project;

(3) One of the questions which no man of finance, no banker, no economist, no judge can answer today is whether or not this country is faced with inflation. The very inability to determine this question is the one having the greatest influence upon investments at the present time. If inflation comes, the debt of this district, whether it be $8,000,000 or $16,000,000, will be an inconsiderable factor in its future welfare, because, even a minor degree of inflation would enable the district to liquidate its debts fully with comparative ease. A plan, therefore, which now determines in effect that there will be no inflation, but, on the contrary probable deflation, is inequitable;

(4) The plan is unfair because but few bonds owned by the appellants have matured and many of them will not mature until the 1950's and 1960's and it is utterly impossible and wholly unnecessary for the Court to determine now what the future holds twenty years hence. The bonds in question are not callable, and the appellants are not asking that they be paid before their maturity. The sudden change in prices of many commodities owing to the second world war in Europe is a factor which the Court could not have anticipated and is but an illustration of the impossibility of determining whether it is fair to pay off an obligation due in twenty years at 50¢ on the dollar now;

(5) The plan is unfair because under California statutes, 1917, page 243, as amended, the district Securities Commission was required to, and did in its order No. 54 (R. 949) determine that the value of the unimproved

land in the District plus the water rights and other works of the district exceeded by at least 40% in value the amount of the second refunding bond issue, that is to say, the amount of the loan from the R. F. C.;

(6) The plan is unfair because the district Securities Commission had only shortly prior to its order No. 54 determined that the district could pay a first refunding bond issue which was for the full amount of the principal of the original bonded debt of over $16,000,000 and that this amount was not over 60% of the value of the bare land and works of the district (R. 497);

(7) The plan is unfair because, even assuming its own theory of the amount of its debts, petitioner has assets far exceeding its liabilities.

The assets of the district disclosed by its balance sheet (Ex. No. 26, R. 669) are the sum of $20,478,901.26.

As we have seen, this figure omitted assets in the sum of at least $1,180,000, being $340,000 of current assessments receivable, and $840,000 equity value of the Crocker-Huffman contracts purchased by the district. Thus total actual physical assets of petitioner exceed $21,600,000, according to its own proof.

The liabilities claimed by petitioner are $6,470,622.47 current liabilities, and $16,191,000 bond liabilities, totaling $22,761,622.47. (R. 669.) We have seen that this figure overstated liabilities by including $1,500,000 of liabilities which had either never accrued or had been paid, thus reducing the liabilities to about $21,200,000. Thus, the undisputed evidence shows petitioner has a surplus of over $400,000.

In addition the district has as an asset the taxing power. Appellant's bonds are general obligation bonds.

Roberts v. Richland Irrig. Dist., 289 U. S. 21, 53 Sup. Ct. 519;

Judith Basin v. Malott, 73 Fed. (2d) 142;

Rohwer v. Gibson, 126 Cal. App. 707;
Bates v. McHenry, 123 Cal. App. 81;
Provident Land Corp. v. Zumwalt, 12 Cal. (2d) 365.

The value of the taxing power as *an asset of the Merced Irrigation District* is so great as, together with the fair value of its other assets, to make the petitioning district overwhelmingly solvent.

Up to about 1932 the assessed value of the lands within the district was set at about $20,000,000, at which time there was a material reduction in assessed value resulting in reducing the assessed value of the district to between eleven and twelve million dollars. (R. 424-425.) Only the land is assessed and not improvements. The assessed value of agricultural land within the district averages $60 per acre. (R. 517.) The average value of land within the district according to the undisputed testimony of petitioner's own witness Momberg is about $135 per acre ($450,000 for 3500 acres). (R. 485.) This was for property that was fairly representative of all the properties within the petitioning district. (R. 473.) The ratio of $60 of assessed value to $135 of actual sales price (petitioner having made 67 actual sales (R. 489), is a ratio indicating that the fair market value is about two and one-fourth times the assessed value.

According to the report of the California State Board of Equalization for 1933 and 1934, the total assessment for taxation of property in Merced County was approximately 35 per cent of its actual value (R. 960) so that according to this report the ratio of actual value to assessed value for the year 1933-1934 was about 2⅚ to 1.

Assuming the lower ratio testified to by Mr. Momberg, the fair market value of the land, *exclusive of improvements,* within the Merced Irrigation District is therefore two and one-fourth times the assessed value of $11,400,000, or at least $25,000,000. The market value of this

land, of course, represents the *equity of the owners of the land* after considering the probable charges for bond service, etc., and for irrigation district operations.

Moreover, the cities of Merced County, practically all of which are in the district, had a property valuation of $21,452,455 (R. 960) in 1929-30, apparently exclusive of operative properties of Public Utilities, which had an assessed value, in the county, in 1935, of nearly $8,000,000.

Certainly a valuation of $25,000,000 on the taxing power of the Merced Irrigation District would be extremely conservative in the light of this undisputed testimony.

Therefore, there must be added to the assets admittedly held by the irrigation district the sum of $25,000,000, which brings the total assets of the district to something over $47,000,000, as against claimed liabilities of about $21,200,000—clearly an overwhelming excess of assets over liabilities, showing solvency clearly.

(8) We now turn to another great money asset of the district. It is the power produced at Exchequer Dam.

If the district is successful in reducing its bond obligation to $8,600,000, as provided for in the plan involved in these proceedings, then to all intents and purposes, from that day on, Merced Irrigation District will be entirely debt free. That condition will be accomplished by taking from the bondholders approximately one-half of their investments.

The district is the owner of a power plant at Exchequer Dam. (Respondent's Ex. "RR", p. 118, Ex. "OO".)

All the power to be produced at this power plant has already been sold on a long term contract. (Respondent's Ex. "EE", R. 945.) It is stipulated that the power contract has been sustained by Court action. (R. 538.)

We now turn to the testimony of Heinze and Hill. The testimony of these two witnesses commences at page 524 of the record. These witnesses are experts of the highest order. Mr. Heinze made a thorough study of the record of the Merced River and based his conclusions upon that record, the actual experience of Merced Irrigation District over the years of its operation, the contract for the sale of the power, including preferential for irrigation purposes, etc. Over the past thirty-four years from the time of his testimony upon what is known as the straight line method of depreciation, had the power plant been in operation all that time, the district would have received an average annual net of $456,058 from its power sales, and if figured on what is known as the 5% sinking fund method of depreciation, and which the witness stated is the common practice before the California Railroad Commission, the average net income which the district would have received over the thirty-four year period would have been $467,932.

If the district succeeds in this proceeding its total bond debt will be $8,600,000 represented by refunding bonds at 4% to be held by R. F. C. and payable over a period of forty years. The witness stated (R. 529) that the amount of $434,300 each year would completely amortize the $8,600,000 bond issue at 4% over a period of forty years. In other words, the new debt of the district would be completely amortized by its sale of power alone based upon its present method of depreciation with something like $22,000 each year left over, and if placed on a 5% sinking fund method of depreciation the district would have left over each year approximately $33,000 on the average.

Put it another way: If the district will simply take its net power revenue over the period of the new refunding bonds that will be delivered to R. F. C. and place

all of that net power revenue in the bond fund, that revenue will considerably more than completely amortize the R. F. C. loan within the life of the bonds. That is why we say that the district will in effect, be entirely debt free, as it will not be necessary for the district to ever levy one penny piece upon the land for bond service, and yet the present bondholder is asked to give up approximately one-half of his investment in order to bring about that very happy condition for the district.

The above testimony of Mr. Heinze was given at the first trial in the United States District Court. Prior to the trial upon which this appeal is made, Mr. Heinze brought his studies down to date and those new studies are represented by Respondent's Exhibit "DD-1" (R. 933) which is still more favorable to the district as two or three rather high years of run-off from the Merced River had intervened. The original studies were made at the end of a very dry period.

Mr. Louis C. Hill (R. 533) confirmed Mr. Heinze but carried his study back 64 years. Both witnesses agreed, which is obvious, that the longer the study the more accurate would be the result. He arrived at a gross annual figure of $533,987, as against a gross return by Mr. Heinze of $500,415. (R. 526.) Mr. Hill stated (R. 538) that by the district adding $32,489 to its average net power return it could completely pay off its new proposed bond issue of $8,600,000 at 4% interest, in thirty years. And yet it is claimed that this plan is fair. These witnesses are not impeached. They are not contradicted. These two engineers are of outstanding ability. Heinze is an electrical engineer of wide experience. Mr. Hill (deceased since his testimony was given) was an engineer of national standing. Of course their figures are estimates, and obviously would not be 100% accurate, but they are

reasonably accurate so far as past records are concerned, one for 34 years and the other for 64 years. As said by Mr. Hill (R. 535) "It is my opinion that looking to the future some 30 or 40 years, the District could reasonably expect the figures to approximate the average figure for the 64 years". Now there is a sufficient leeway between the amount necessary to amortize the new proposed bond issue and the amount of net revenue that the district could reasonably expect to receive from its power sales, so that it may be taken as an established fact that the district will receive an average amount of net income from its power sales to completely amortize the new proposed bond issue without ever being required to levy a single penny upon the land for bond service.

It is readily recognized that there will be high power income years and low power income years. That cannot matter. The average for the future will no doubt be very nearly what it would have been in the past and we know what those years would have produced. Furthermore the above computation is based upon the contract which will expire in 1964, some ten years before the last of the refunding bonds will mature; but that is quite immaterial for two reasons. First, it may be presumed that the price of power after 1964 will not be materially different. There is no evidence upon the subject. Second, the district is setting up a depreciation so that the plant may be entirely rebuilt at a given time. In other words, in 1964 the district will own, in effect, if not actually, a brand new plant, entirely paid for, of a value several or many times the amount of the then unpaid refunding bonds. A net income of more than $400,000 capitalized produces a very large figure. It will be remembered that this power plant is being depreciated so that long after all present debts are paid, the district will still be the owner of this valuable asset.

(9) The reasonable income capacity of the petitioner district is sufficient to pay off its debt in full, on petitioner's own theory.

As we have seen, petitioner has for six years levied a very low tax under Section 11 of the Districts Securities Commission Act. (Appendix, p. i.) On our theory of the R. F. C. debt, this was not particularly harmful, since petitioner has more than twice as much cash on hand as is necessary to pay all matured obligations. On petitioner's theory, however, the result of this action was to accumulate matured unpaid bond coupons of $4,-082,919, $875,787.54 interest on registered bonds and coupons, and $387,000 matured principal, totaling $5,345,706.54 matured bond liability (R. 886) against which should be credited cash on hand totaling more than $1,500,000, leaving a net past due maturity to be paid from other sources of about $3,900,000.

While this debt is not due until collections are made for payment, as determined in *Moody v. Provident Irrigation Dist.,* supra, and under the provisions of Section 11 of the Districts Securities Commission Act, it would be preferable to refund the entire debt of the district on a more scientific basis.

The total debt to be refunded, on petitioner's theory, matured and unmatured, is slightly less than $20,000,000. In accordance with modern financing practice this debt, being for improvements of a permanent nature, not subject to heavy depreciation, should be repaid over a fifty-year period in equal semi-annual installments, including both principal and interest. The interest rate would not exceed 5%, and the annual debt service on that basis would be $1,092,476. (*Montgomery's Financial Handbook* (2 ed.), pp. 1417, 1422.) It is apparent that taking account of power revenue, and the wealth of the district generally, this amount could be carried without distress.

And under the modification of petitioner's plan proposed by appellants, petitioner's financial burdens would be much less. That proposed modification (R. 164), was that the rate of interest on petitioner's bonds be reduced to 3% from the date of default in payment of interest (July, 1933) to maturity.

Assuming petitioner's theory that all of the bonds are still owing, this would reduce the amount of interest now overdue (still assuming all of the bonds are owing), by a saving of $1,792,395; and would reduce interest charges from the present time on, so as to effect a saving of $465,200 per year from the present time until payment of principal. The annual saving in the future will of course be reduced as the principal sum is reduced.

(10) *Merced Irrigation District comprises a fertile and good section of the State.*

The Court will take judicial notice of many of the important features of this great district. The Court knows judicially that this governmental agent of the State occupies a large area near the geographical center of the great San Joaquin Valley, and of the general soil, water and climatic conditions. (*Greeson, et al. v. Imperial Irrigation District, et al.*, 59 Fed. (2d) 529.)

Respondent's Exhibit "RR" found at page 118 of Exhibit "OO" which is volume 4 of the transcript, states that the district is the fifth largest district in California, and one of the most important and has a gross area of slightly more than 189,000 acres, and is located on two main line railways and two branch railways, and indicates that the district has a good water right with ample storage and a power resource of very great value.

Mr. Covell testified (R. 543-546): that for many years he had been entirely familiar with the lands in Merced Irrigation District and similar areas at other places in

the State and indicated further that he knew the general situation very well and indicated that the lands in Merced Irrigation District compare quite favorably with other good sections of California.

Adverting again to Respondent's Exhibit "RR" commencing at page 118 of volume 4 of the transcript, it is stated that the soils are mostly of the Fresno, Madera and San Joaquin series.

Turning to Respondent's Exhibit "AAA" we find excerpts from the United States Department of Agriculture, Bureau of Soils (Tr. p. 987) where it is indicated that Madera loam ranks among the best soils of the survey, and that Oakley and Fresno sands rank among the most important of the survey for intensive crops, etc.

Respondent's Exhibit "XX" consists of excerpts from Bulletin 21a of the State Department of Public Works. (R. 975-978.) This table reports on 69 irrigation districts in California, and indicates that there were 39 districts with higher water costs per acre in 1929 than Merced, and there were 45 irrigation districts with a higher water cost per acre foot than Merced.

Respondent's Exhibit "ZZ" (R. 979-985) indicates, first, that this district has a very large and dependable storage supply of water.

Table II of Respondent's Exhibit "ZZ" is a crop report for 1934, and shows Merced to be one of the most fully diversified of any of the districts in California.

Table V of said Exhibit "ZZ" shows some 16 irrigation districts in California with a higher irrigable acre bond debt than Merced, and that of course is not counting the power resources. Without trying to compute it to any nicety, it would appear that if the power asset of Merced Irrigation District were capitalized and applied against

the bonds as originally outstanding, there would be something like thirty irrigation districts with higher per irrigable acre bond debt than Merced.

In considering a comparison between Merced and other comparable districts, such as the outstanding Turlock Irrigation District, it will be kept in mind that the costs above referred to in Merced District include delivery to each 160 acres of land, whereas in some other district such as Turlock, delivery is made only in the laterals and the farmer must pay the additional cost of taking the water to his land. (Bottom p. 130, Benedict Report, Petitioner's Ex. No. 35, set out in separate volumes.) From the evidence it is indicated that Merced Irrigation District is one of the better agricultural communities of the State. It has good soil. It has good transportation facilities. It is admirably located. It has one of the best water supplies in California. It produces diversified crops. Its obligations are not materially higher than others. In other words, it is a good agricultural community and is not in need of charity from its bondholders or others.

(11) No attempt was made by the district to meet the contention that its financial condition on June 17, 1938 (the date of the filing of the petition herein) was entirely different from its financial condition on April 19, 1935, the date of the filing of the prior petition. The two plans are identical in all respects. Appellants' Exhibit A (R. 852), shows that the cash balance in all funds of the district on December 31, 1934 was $346,313.61. Exhibit 26 shows that the cash in the funds of the district on November 1, 1938, was $1,578,446.14. (R. 669.)

FIFTH PROPOSITION: THE CLAIMS WERE IMPROPERLY CLASSIFIED AS BEING ALL OF THE SAME CLASS.

Assignment of Error No. 19 reads

> "The Court ered in classifying the creditors, including the Reconstruction Finance Corporation, as one class." (R. 285.)

The Judge erroneously classified all of the claims as of the same class. Section 83(b) provides,

> "The holders of claims for the payment of which specific property or revenue are pledged, or which are otherwise given preference as provided by law, shall accordingly constitute a separate class or classes of creditors."

In *In re James Irrigation District,* 25 Fed. Supp. 974, which case was decided simultaneously with the instant case, the Court held that where the fund is earmarked and limited, it must be prorated among all bondholders.

Section 52 of the California Irrigation District Act expressly provides that upon presentation of a matured bond or coupon to the Treasurer for payment he shall pay the same from the bond funds.

The leading case in California construing this provision is *Bates v. McHenry,* 123 C. A. 81, which was a case involving the Merced Irrigation District. Bates brought suit to compel payment of interest coupons at a time when there were not funds sufficient to pay all the matured interest coupons. The Court directly held that it was the duty of the Treasurer to do two things:

> "He must either pay the bond or interest coupon when presented or register the same. The irrigation laws do not confer upon the Treasurer of the District any authority to prorate payments."

It is to be observed that at the time this opinion was rendered there was on hand insufficient funds to pay all the interest due.

This case and its doctrine has been followed by all Courts in California ever since. The decisions which affirm the doctrine there stated are: *Selby v. Oakdale Irrigation District,* 140 C. A. 171; *Morris v. Gibson,* 88 C. A. D. 703; 89 C. A. D. 140; *Shouse v. Quinley,* 3 Cal. (2d) 357; *Rohwer v. Gibson,* 126 C. A. 707; *Strasburger v. Van Derlinder,* 17 C. A. (2d) 437, and most recently *El Camino Irrigation District v. El Camino Land Corporation,* 96 C. D. 505, and *Provident Land Corporation v. Zumwalt,* 12 Cal. (2d) 365. The two cases last mentioned involved admittedly insolvent irrigation districts *which no longer had even a theoretical inexhaustible* taxing power, for the bulk of the lands within these districts were already owned by the districts themselves through tax title process, the Court saying in the last-mentioned case:

> "The delinquencies have gone too far in this and other districts to save the landowners."

These two last-mentioned decisions reaffirm the principle of payment of matured bonds and coupons in the order of their presentation to the Treasurer for payment despite insolvency.

It is therefore apparent that within the meaning of the words of Chapter 9 "preference as provided by law" those bondholders who hold matured bonds or matured coupons which have been presented to the Treasurer for payment have been given a preference by law, which preference must be recognized by the bankruptcy court in classifying creditors.

Each matured bond and coupon when presented for payment becomes "a separate class."

Now the District Judge laid aside this principle of priority, clearly established by California decisions, in favor of the principle of prorating payments which was alluded to in the *Kerr Glass Case,—Kerr Glass Mfg. Co. v. City of Buenaventura,* 62 Pac. (2d) 583, 7 Cal. (2d) 701. This was error.

The Facts Applicable.

All the appellants made and filed proofs of claims, and answers in the proceedings. (R. 341.) The claims and answers of substantially all of the appellants show their ownership of matured bonds and coupons and presentation of the same to the Treasurer for payment, for example, the answer of Morris (R. 103) and the answer of Bekins et al. (R. 116), West Coast Life Ins. Co. (R. 108.) The stipulation of the parties (R. 144) provided that such claims could be shown by answer or by claim and the stipulation (R. 542) admits ownership. The fact of presentation for payment is shown at R. 400.

On the other hand, although it was shown (R. 349) that bonds purportedly held by the R. F. C. have been registered in their name, there is, as has been repeatedly stated, no claim of the R. F. C. on file in these proceedings.

Whatever may be the actual order of presentation of matured bonds and coupons to the Treasurer for payment under Section 52, this much is clear, that under California law a *preference by law* is given thereby and the bankruptcy court can only apply and use the bond funds and other trust funds and property belonging to the bondholders upon the payment thereof in the order of such presentation. Such application as between a bondholder having an unmatured bond and a bondholder having a matured bond would require payment in full of the matured bond, if presented, before any trust funds could be applied upon payment of the unmatured bond. This

seems to be the positive injunction of Chapter IX, and whether it destroys the plan of composition or not, must be observed.

This same principle applies to the next subject now discussed.

SIXTH PROPOSITION: THE DECREE UNLAWFULLY TAKES TRUST FUNDS AND VESTED RIGHTS BELONGING TO THE APPELLANTS.

Assignment of Error No. 22 reads:

> "The court erred in entering a decree herein taking vested rights of the appellants."

Assignment of Error No. 23 reads:

> "The court erred in taking jurisdiction of the public trust imposed upon the Merced Irrigation District under the California Irrigation District Act and in administering the same and in depriving the appellants of their rights as beneficiaries of such trusts."

The following trust funds and vested rights are subject to this rule:

(1) The right to a writ of mandate to compel payment of trust moneys to bondholders and to compel a levy of assessment is a vested right.

Except for the effect of the bankruptcy statute the appellants were at the time of the filing of the petition entitled to writs of mandate to compel the application of trust funds to the payment of appellants' matured claims and to compel levy of assessments. *Moody v. Provident Irrigation District,* 96 C. D. 512; *El Camino Irrigation District v. El Camino Land Corporation,* 96 C. D. 505; *Selby v. Oakdale Irrigation District,* 140 C. A. 141. In fact, the only remedy which a bondholder had was his right to a writ of mandate under these decisions.

Where the writ of mandate is thus given it is a writ of right. *Borough of Fort Lee v. U. S.,* 104 Fed. (2d) 275.

(2) The money belonging to the bond funds are trust funds in which the appellants had a vested right. *Selby v. Oakdale Irrigation District,* supra; *Provident Land Corporation v. Zumwalt,* 12 Cal. (2d) 385.

(3) Other trust properties which are taken by the bankruptcy decree are the following:

(a) Trust funds which have been unlawfully diverted and which should be replenished from funds on hand (R. 412-414)	$717,932.50
(b) Tax deeded lands (R. 678)	672,885.14
(c) Rentals, including water tolls per year (R. 881)	60,000.00
(d) Tax Sale Certificates (R. 889)	206,096.93
(e) In addition, all assets not needed for the operation and maintenance of the district.	

In the case of *Clough v. Compton Delevan Irrigation District,* 96 C. D. 509, the Court referred to Section 29 of the California Irrigation District Act. Section 29 reads in part:

> "The legal title to all property acquired under the provisions of this Act shall immediately and by operation of law vest in such Irrigation District and shall be held by such District in trust for and is hereby dedicated to and set apart for the uses and purposes set forth in this Act."

In the last-mentioned case the Court construing Section 29 said:

> "The property is by this language impressed with public use, and the trust is for all the purposes of the Act. Payment of the bondholders is such a purpose. * * *".

In the case of *McKaig v. Moutrey,* 9 C. A. D. 335, 90 Pac. (2d) 108, the Court said:

> "The officers and directors became trustees for the district and its bondholders when the assessment to pay bond principal and interest was levied, and the assessment when so levied, became the property of the district and was held in trust for the bondholders under section 29 of the Irrigation District Act."

It is respectfully contended that this decree unlawfully takes trust properties belonging to the appellants.

SEVENTH PROPOSITION: BY THE TERMS OF THE STATUTE THE COURT WAS WITHOUT JURISDICTION.

Assignment of Error No. 7:

> "The Interlocutory Decree in this cause interferes with the political and governmental powers of the Merced Irrigation District and the property and revenues thereof necessarily essential for governmental purposes."

Assignment of Error No. 8:

> "By the provisions of Section 83 of the Bankruptcy Act the court is without power to apply its order to this irrigation district."

It is respectfully suggested that the Court was wholly lacking in jurisdiction. The petitioner being exclusively governmental in nature seems to be entirely excluded by the terms of the act under which these proceedings were prosecuted.

In Section 83 (c) of the Bankruptcy Act, which is Section 403, Title 11, U. S. C., after stating that the Court may enjoin proceedings and put the plan temporarily into effect, it is provided:

"* * * but shall not, by any order or decree, in the proceeding or otherwise, interfere with (a) any of the political or governmental powers of the petitioner; * * *".

To make doubly sure that the political or governmental affairs of the State were not to be interfered with, Congress inserted in the Act subdivision (i) of the same section (83) which reads as follows:

"(i) Nothing contained in this chapter shall be construed to limit or impair the power of any State to control, by legislation or otherwise, any municipality or any political subdivision of or in such State in the exercise of its political or governmental powers, including expenditures therefor."

Then further, to guard against the Act failing entirely because some petitioner might be a governmental agent Congress inserted:

"That if any provision of this chapter, or the application thereof to any such taxing agency or district or class thereof or to any circumstance, is held invalid, the remainder of the chapter, or the application of such provision to any other or different taxing agency or district or class thereof or to any other or different circumstances, shall not be affected by such holding."

Tit. 11, Sec. 401, U. S. C.

Subdivision (c) 11 of the old section 80 is as follows:

"But (11) shall not, by any order or decree, in the proceeding or otherwise, interfere with (a) any of the political or governmental powers of the taxing district."

The similarity between Subdivision (c) 11 of Section 80 and Subdivision (c) of Section 83 above quoted is at once striking. Indeed they are identical with one exception. The last two words of the old act are "taxing district"

and the last word of the new act is "petitioner". This difference may be more important than it at first appears. The Court held the old act unconstitutional in the *Ashton* case. (*Ashton v. Cameron County Water Improvement Dist. No. 1,* 298 U. S. 513.)

The basis of the decision in the *Ashton* case may be stated in two or three rather short quotations from that opinion where the Court said (531):

> "If obligations of States or their political subdivisions may be subjected to the interference here attempted, they are no longer free to manage their own affairs; the will of Congress prevails over them; although inhibited, the right to tax might be less sinister. And really the sovereignty of the State, so often declared necessary to the federal system, does not exist."

And again:

> "The constitution was careful to provide that 'No state shall pass any law impairing the Obligation of Contracts'. This she may not do under the form of a bankruptcy act or otherwise." (Authority.) "Nor do we think she can accomplish the same end by granting any permission necessary to enable Congress so to do."
>
> "Neither consent nor submission by the States can enlarge the powers of Congress; none can exist except those which are granted." (Authority.) "The sovereignty of the State essential to its proper functioning under the Federal Constitution cannot be surrendered; it cannot be taken away by any form of legislation."

The new act, so far as the constitutional question is concerned, was approved in the *Bekins* case (*U. S. v. Bekins,* 304 U. S. 27). After quoting at some little length from the report of the Judiciary Committee of the House, which committee report we will presently refer to, Mr. Chief Justice Hughes stated (51):

> "We are of the opinion that the Committee's points are well taken and that Chapter X is a valid enactment. The Statute is carefully drawn so as not to impinge upon the sovereignty of the State."

It will be observed that the Court in the *Bekins* case does not assent to the proposition that the sovereignty of the State may be impinged upon.

The material differences between the two statutes, if any there be, are elusive in the extreme. The *Ashton* case held the act void. The *Bekins* case holds a very similar act valid. One of two things, therefore, seems certain. The Court in the *Bekins* case must have either found some material difference between the old and the new statutes, even though slight it may be, which clears away the difficulties found in the old statute, or the *Ashton* case is actually overruled. If the *Bekins* case overrules the *Ashton* case, then the plea in this case of *res judicata* would seem to be perfectly good, but that is another point which we are not here discussing, but will presently discuss.

The Court in the *Bekins* case (50) referring to the *Ashton* case and its holdings in that case, stated:

> "* * * that if obligations of States or their political subdivisions might be subjected to the interference contemplated by Chapter IX, they would no longer be 'free to manage their own affairs.'
>
> In enacting Chapter X the Congress was especially solicitous to afford no ground for this objection."

The Court does not give us the differences between the two acts or wherein the solicitation of Congress has removed the objection found in the *Ashton* case, but unless the Court actually overruled the *Ashton* case, it must have found some difference upon this particular point and that difference may be as between the words "petitioner" set

out above from Section 83 (c) and the words "taxing district", set out above from Section 80 (c) (11). And we can see some little difference between those terms.

In the old Act the term "taxing district" was defined as,

> "any municipality or other political subdivision of any state, including (but not hereby limiting the generality of the foregoing) any county * * *", etc.

including irrigation districts.

Now, the Court in the *Ashton* case held the old act void. The respondent in that case was a water improvement district exactly similar to an irrigation district. The Court said:

> "If Federal Bankruptcy laws can be extended to respondent, why not to the State?"

It will be remembered that in the old Act the respondent was defined as a political subdivision. Again in the same decision the Court said (527):

> "It is plain enough that respondent is a political subdivision of the State, created for the local exercise of her sovereign powers, and that the right to borrow money is essential to its operations. * * * Its fiscal affairs are those of the State, not subject to control or interference by the national government, unless the right so to do is definitely accorded by the Federal Constitution."

Now we turn to the new act, the one construed in the *Bekins* case, and we find the term "petitioner" defined in Section 82 as "any taxing agency or instrumentality referred to in Section 81 of this Chapter."

When we look at Section 81 we find that irrigation districts and numerous other agencies are named by name but they are not defined as political subdivisions, and at the end of Section 81 we find this very significant language, already quoted above:

> "Provided, however, that if any provision of this chapter, or the application thereof to any such taxing agency or district or class thereof or to any circumstance, is held invalid, the remainder of the chapter, or the application of such provision to any other or different taxing agency or district or class thereof or to any other or different circumstances, shall not be affected by such holding."

The *Ashton* case had held old Chapter IX to be void because it permitted interference with the governmental sovereignty of the State. The *Bekins* case seems to hold that the governmental intereference has been avoided in the new statute, at least so far as its general constitutionality is concerned.

When we turn to the new statute we find that Congress has named a great number of agencies, and, not being sure but that some of these agencies may be strictly governmental and thus fall into the category condemned in the *Ashton* case, it provides at the end of Section 81 as above quoted and proceeds to at least attempt to save the act as to those which do not fall within the class which Congress has no power to interfere with.

Since all of the agencies in the old act, by definition of Congress, fell within the sovereign governmental class the old act was condemned in its entirety. Now, since it is possible that some or perhaps a large number of the agencies named in the new act would not come within that class, the act as a whole is not condemned, and it is not condemned as to the particular agency before the Court, because the Courts of California had not held such agencies to be strictly governmental. This seems to be a reasonable construction to place upon the *Bekins* decision, and indeed seems to be about the only way that it can be explained without reaching the conclusion that the *Ashton* case is actually overruled.

This construction seems to be borne out further by the decision in the *Bekins* case where the Court quotes with approval from the report of the Judiciary Committee of the House and States (51):

> "The bill here recommended for passage expressly avoids any restriction on the powers of the States or their arms of government in the exercise of their sovereign rights and duties. *No interference with the fiscal or governmental affairs of a political subdivision is permitted.* * * * No involuntary proceedings are allowable, and no control or jurisdiction over that property and those revenues of the petitioning agency *necessary for essential governmental purposes is conferred by the bill.*" (Italics supplied.)

Now, the committee of Congress apparently had this very point in mind, namely, that it could not pass an act that would apply to a state or to any strictly governmental agent or the state but only to those agencies that exercised private or proprietary functions. Congress seemed to recognize that the first act had failed largely because, if not entirely because, it applied entirely, by definition, to municipalities and political subdivisions which exercise governmental or sovereign powers. In the new act it tried to avoid that difficulty by withholding jurisdiction from the Court to deal with those agencies which are strictly governmental and the governmental functions of the agencies which may be partly governmental and partly proprietary.

We now come to a consideration of the nature of an irrigation district in California.

It is not important on this particular point whether the *Ashton* case was actually overruled or not. Congress in the very act under which such jurisdiction as the Court could exercise was conferred, expressly provided that no order could be made that would interfere with any of the political or governmental powers of the petitioner. It be-

comes important therefore to ascertain whether or not the petitioner has any powers which the Court had the right, by its order, to interfere with.

For many years the exact nature of an irrigation district has been a subject of judicial concern. That question has been definitely crystalized in California, so far as California irrigation districts are concerned, *since the decision in the Bekins case.*

In the case of *El Camino Irrigation District v. El Camino Land Company,* 12 Cal. (2d) 378, 383, the Court states:

> "But the cases make a sharp distinction between municipal corporations, such as the cities in the Kuback Co. and Marin Water and Power Co. cases, and state agencies such as irrigation or reclamation districts. These latter are agencies of the state whose functions are considered exclusively governmental; their property is state owned, held only for governmental purposes; they own no land in the proprietary sense, within the rule of defendant's cases. (See Whiteman v. Anderson-Cottonwood Irrigation District, 60 Cal. App. 234; Turlock Irrigation District v. White, 186 Cal. 183, 187; Wood v. Imperial Irrigation District, 216 Cal. 748, 752.)"

The still more recent case decided by the Supreme Court of California is that of *Anderson-Cottonwood Irrigation District v. Klukkert, as Assessor,* 97 C. D. 348, 352. In the *Anderson-Cottonwood* case the District had taken over a good deal of land through its assessment proceedings and the County Assessor was threatening to assess these lands for county tax purposes and the proceeding was one to prohibit such an assessment. The Court reviewed the authorities at some length and said:

> "Irrespective of that which hereinbefore has been stated with respect to the rule that under a constitutional provision exempting state-owned property from taxation it is immaterial whether the property is held

in a proprietary or a governmental capacity, it does not appear that the lands here involved are non-operative, within the meaning contended for by respondents. In the recent case entitled El Camino Irrigation District v. El Camino Land Corporation et al., 96 Cal. Dec. 505, at pages 508, 509, this court held that an irrigation district was an agency of the state, whose functions were considered exclusively governmental; that it owns no lands in a proprietary sense, *its property being owned by the state and held only for governmental purposes.* The court pointed out that under section 29 of the Irrigation District Act (Deering's Gen. Laws (1931), Act 3854, p. 1948) it was provided that property acquired by the district should be held 'in trust', and was 'dedicated and set apart to the uses and purposes' set forth in the act. (See, also, Clough v. Compton-Delevan Irrigation District et al., 96 Cal. Dec. 509, 511; Moody v. Provident Irrigation District, 96 Cal. Dec. 512, 515.) Also, in the recent case entitled Provident Land Corporation v. Zumwalt et al., 96 Cal. Dec. 497, where the economic history of irrigation districts in this state was reviewed at some length, it was held that lands acquired by the district under the provisions of the Irrigation District Act remain in trust, and that their proceeds, whether by sale or lease, were likewise subject to the trust."

A still more recent case is that of *Glenn-Colusa Irrigation District v. The Board of Supervisors of Colusa County,* 96 C. A. D. 882. In that case the irrigation district had in a warehouse, a certain amount of grain that had been taken as rental for tax deeded lands held by the District. The County assessed the grain, the District applied to the Board of Supervisors to cancel the assessment, which was refused, and an application was made to the Court for an order compelling the cancellation of the assessment. The assessment was cancelled on the ground that the District owned no property in any proprietary

sense but wholly in a governmental sense and was not subject to taxation.

Now the law in California is no different today than it has always been. Our Courts have simply told us what the law is, in relation to the nature of an irrigation district and that is, that it being purely a creature of the state for state purposes, all the functions of such a district are governmental.

Congress has stated that the Court shall not by any order or decree in the proceeding or otherwise interfere with any of the political or governmental powers of petitioner. If all of the powers and functions of the petitioner are governmental, then it would seem too clear for argument that the Court could make no valid order or decree in these proceedings.

It may be argued that no order or decree contemplated in these proceedings would *interfere* with any of the functions of the district. The slightest reflection demonstrates that such is not the case. One of the functions of the district is to borrow money and issue bonds. Another function enjoined by law and for the enforcement of which mandamus will lie is the levying of assessments to pay the bonds in full according to their terms. Whereas, now mandamus will lie to require the levying of such an assessment, after the order in this proceeding is final, an injunction will lie to prohibit such an assessment. The whole purpose of the proceeding is to change the fiscal affairs of the district. After that change has been made the district will have no power to proceed on the old basis established by State law but will be required to proceed upon the new basis established by the Federal Bankruptcy Court.

In the *Bekins* case Mr. Chief Justice Hughes in referring to the *Ashton* case said:

> "* * * the court considered that the provisions of Chapter IX authorizing the bankruptcy court to entertain proceedings for the 'readjustment of the debts' of 'political subdivisions' of a State 'might materially restrict its control over its fiscal affairs', and was therefore invalid; that if obligations of States or their political subdivisions might be subjected to the *interference* contemplated by Chapter IX they would no longer be 'free to manage their own affairs'." (Italics supplied.)

Now, we have the *Bekins* case either overruling the *Ashton* case (supra) or finding something in the new act that saves the governmental or sovereign functions of the petitioner from the effects of the new act. We have our own State Court holding flatly and unequivocably that every function of the irrigation district is a governmental function and that it owns no property of its own but the property which stands in its name is the property of the State and is used for governmental purposes and impressed with a trust for that purpose, and that it is neither subject to execution nor taxation. We find the act under which these proceedings are pending expressly prohibiting the Court from making any order or decree that will interfere with the political or governmental functions of petitioner, and we find that no order or decree could be made that would not interfere with one or more of these governmental functions.

So it would appear that there is only one possible basis left upon which the Court could exercise any jurisdiction in these proceedings and that is for the Court to take the position that the Federal Court is not bound by the State Court decisions and that actually these great sovereign functions of taxation which are exercised by the petitioner and which will be directly affected by the decree in this proceeding and will have to be exercised in the future in

accordance with such decree are, after all, not governmental at all but are in the nature of private functions.

The Supreme Court in the *Tompkins* case held that on questions of State law United States Courts are bound by the decisions of the State. (*Tompkins v. Erie Railroad Company,* 304 U. S. 64.)

Section 34 of the Judicial Code, Title 28, Section 725 U. S. C. A. provides:

> "The laws of the several States, except where the Constitution, Treaties, or statutes of the United States otherwise require or provide, shall be regarded as rules of decision in trials at common law, in the courts of the United States, in cases where they apply."

The irrigation district is a creature of statute and the highest court of the state that brought the district into existence, has interpreted its charter. That interpretation is laid beside the act of Congress and by that act the district is apparently excluded from its operation.

It has been a general rule of construction since the earliest time that the United States Courts will follow the State Court in a construction of a State statute or a State constitutional provision.

Town of South Ottawa v. Perkins, 94 U. S. 260, 267.

The recent California Supreme Court decisions above cited, are but crystallizations, as it were, of the older cases on the same points. Those cases are reviewed to some extent in the *Anderson-Cottonwood* case and it would seem that even in the absence of the *Tompkins* case the United States Courts would be bound by the State decisions as to the nature of an irrigation district.

The position taken is greatly strengthened by subdivision (i) of Section 83 where it is stated:

> "Nothing contained in this chapter shall be construed to limit or impair the power of any state to control,

> by legislation or otherwise, any municipality or any political subdivision of or in said state in the exercise of its political or governmental powers, including expenditures therefor."

Now, there are just two ways, with which we are familiar, by which the State may control anything. First, is by legislation and second is by judicial construction. In these proceedings we have pleaded another action pending under a state law. The legislature of the State passed what is referred to as the Irrigation District Refinancing Act. (1937 Stats. p. 92.) That act sets up machinery for accomplishing substantially the same thing that the bankruptcy statute purports to authorize. This district proceeded under that statute and the action is still pending. That statute has not been repealed. So the legislature has itself stepped in and set up procedure for accomplishing a similar purpose and to that extent has undertaken the control of these agencies. That subject, however, we will discuss under another heading.

Since Congress itself has expressly provided that the Court is without power to make any order or decree interfering with the political or governmental powers of the petitioner it would seem that the Court is entirely without jurisdiction to make any order or decree in these proceedings.

Apparently this same point was raised in the case of *George E. W. Luehrmann, et al. v. Drainage District No. 7 of Poinsett County, Arkansas,* decided June 13, 1939, by the Circuit Court of Appeals for the Eighth Circuit. (104 Fed. (2d) 697.) In that case the Court said:

> "A former Act (May 24, 1934) permitting municipal corporations and other political subdivisions of states, unable to pay their debts as they mature, to resort to the federal courts of bankruptcy to effect readjustment of obligations, was before the Supreme Court in Ashton v. Cameron County Water Improvement District No. 1, 298 U. S. 573. It was there held that

the power claimed in support of the Act, as applied to the district organized to permit water for irrigation and domestic purposes, having power to sue and be sued, issue bonds, and levy and collect taxes, was unconstitutional, as restricting the states in the control of their fiscal affairs. The appellant district there was held to be a political subdivision of the state.

The Act of August 16, 1937, under which this proceeding was brought, undertakes to meet the constitutional weakness of the former Act by the following provisions:

> 'That if any provision of this chapter, or the application thereof to any such taxing agency or district or class thereof or to any circumstance, is held invalid, the remainder of the chapter, or the application of such provision to any other or different taxing agency or district or class thereof or to any other or different circumstances, shall not be affected by such holding.'
>
> (11 U. S. C. A. 1222, Sec. 401.)

In Drainage District No. 2 of Crittenden County, Arkansas v. Mercantile Commerce Bank & Trust Company, 69 F. (2) 138, this court held that an Arkansas Drainage District is *not a governmental agency* as respects the question of whether the district is subject to equity jurisdiction. This ruling is based upon the decisions of the Supreme Court of Arkansas holding that drainage districts are quasi-public corporations which are not political or civil divisions of the state like counties and municipal corporations created to aid in the general administration of the government. They are not created for political purposes, nor for the administration of the government. *Appellants do not contend* that the petitioner falls within the limitation upon the power springing from this amendment to the Bankruptcy Act, which limitation was declared in the Ashton case. * * * It appears further that unless and until that composition is effected, the district is hopelessly insolvent, and that the Act of August 16, 1937 is valid as applied to this drainage district, which is not a *governmental agency.*'' (Italics supplied.)

EIGHTH PROPOSITION: THERE IS ANOTHER ACTION PENDING IN THE STATE COURTS OF CALIFORNIA UPON THE IDENTICAL CAUSE OF ACTION AND DEMANDING THE SAME RELIEF, AND THAT THAT ACTION WAS COMMENCED AND PENDING UNDER STATE LAW PRIOR TO THE PASSING OF CHAPTER X OF THE BANKRUPTCY ACT UPON WHICH THIS PROCEEDING WAS PROSECUTED.

Assignment of Error No. 5: "The proceedings herein were and are barred by proceedings pending in the Superior Court of the State of California under the provisions of Statutes of California 1937, Chapter 24". (R. 283.)

In March 1937, there was passed by the California Legislature as an urgency measure, which took effect upon its approval, an act designated "Irrigation District Refinancing Act". (1937 Stat. p. 92.)

Briefly that act provides that any irrigation district being unable to pay its debts as they mature, such debts may be liquidated, refinanced, or readjusted as therein provided. Such a proceeding is initiated by the Board of Directors of the district who shall adopt a plan. The plan must be concurred in by two-thirds in principal amount of the holders of each class of security affected thereby. The plan shall be presented to the California Districts Securities Commission and if found to be fair and equitable to the creditors the Commission shall approve the same and the board of directors is then authorized to file in the Superior Court in the county in which the district or the major part thereof is located, a verified petition stating that the district is unable to meet such obligations as they mature; that it desires to effect the plan adopted and that it has been accepted by a sufficient number of creditors, and the district desires to avail itself of the act. The Act provides that after the petition is filed the plan shall temporarily be in effect and that the filing of the petition shall automatically enjoin and stay, pending final determination of the proceedings as therein set forth, the commencement or continuance of

proceedings or suits against the district or any officer thereof and shall enjoin and stay the enforcement of any lien or the levy of assessments except as is consistent with and in furtherance of the plan and that the Court in which the petition is filed shall have *exclusive jurisdiction* (Sec. 5 of the Act) with respect to all suits, actions and proceedings against the district on account of the indebtedness affected.

It is then provided in the act that 90 days' notice of hearing be given and that thirty days' notice be personally served upon all known holders of bonds and warrants affected by the plan and at any time prior to the hearing any creditor affected by the plan may file an answer; that changes or modifications may be made, and the Court if it finds the plan to be fair and equitable and that it complies with the provisions of the act and has been accepted in writing by the required number of creditors and the offer and acceptance are in good faith and that the district is authorized to take the necessary action to carry out the plan, shall make an interlocutory judgment approving the plan. This decree does not enforce the plan as against non-consenting creditors.

A separate hearing follows in which the rights of non-consenting creditors is determined. This latter hearing is in the nature of a condemnation proceeding.

There are two other provisions of the act to which we wish particularly to direct the Court's attention. They are Sec. 19 and Sec. 5.

Sec. 5 which is entitled "Automatic Stay" provides:

> "* * * The Court in which said petition is filed shall have exclusive jurisdiction with respect to all suits, actions and proceedings against the district—and all matters incidental and collateral thereto * * *"

and the section operates to stay all such suits and proceedings.

The Supreme Court of California in the case of *Morris v. South San Joaquin Irr. Dist.*, 9 Cal. (2d) 781, held that *it,* the Supreme Court, could not properly proceed with the conduct of a writ of mandate matter to compel payment of bonds and coupons while a proceeding under this state act was pending.

Section 19 of the act has a rather startling legislative declaration which shows how completely the state Court has and maintains jurisdiction. We quote the following excerpt:

> "In the event that said petition for liquidation, refinancing or readjustment is dismissed, or that any of the provisions hereof for confirmation of the plan or acquisition of the bonds or warrants of the non-accepting holders shall be declared invalid, such dismissal or declaration shall not affect the effectiveness of the plan with respect to the district or holders of bonds or warrants accepting the same."

In other words, by this section it appears that the legislature intended that when a plan has been adopted and has been accepted by the requisite number of creditors and a proceeding started that no matter what may happen thereafter in that proceeding the plan is in effect and both the district and the accepting creditors are bound by it.

It will be recalled that the petition of the district under the state act was filed in the state Court at Merced in July, 1937, and the bankruptcy act under which the district is now attempting to proceed in this Court was not passed by the Congress until August of the same year. These dates are all important.

These appellants took the position at the time the action was filed in the state Court and have continued to hold that position that the state act is unconstitutional, but neither the petitioner nor the Court in which the action was pending has agreed wih appellants in that respect, and the petitioner and the Court, over the protest of the

appellants, continued to the point where judgment was ordered in favor of the petitioner. (R. 381-383.) Of course the very strong presumption is that the act is constitutional, and the constitutional question cannot be here discussed as it is entirely collateral to this proceeding.

It is extremely interesting to note that neither the petitioner nor the state Court seemed to regard the Federal Act as in any manner affecting the right or jurisdiction of the state Court to proceed. The Federal Act was passed in August, 1937. Notwithstanding that Act, the petitioner brought its state action under the state act to trial and it was as late as March 10, 1938, that the state Court ordered judgment entered in the state action under the state act as prayed for by the petitioner. (R. 381-383.) It was not until long after the Supreme Court of the United States had passed upon the new bankruptcy act that petitioner decided to suspend prosecution of the state proceeding and go to the bankruptcy Court. That cannot be done. The petitioner elected to proceed under the state act in the state Court and it must stay with that proceeding at least until there is a finality to that proceeding. That point has not yet been reached. We have seen by the terms of Section 19 of the Act how complete that election is. It apparently cannot be abandoned.

It will be recalled that these respondents were brought into the bankruptcy Court under Chapter IX of the Bankruptcy Act back in 1935. (Exs. "P", "Q", "R", R. 797, 798.) After Chapter IX was held unconstitutional by the Supreme Court the District Court dismissed that proceeding. (R. 798.) Then the petitioner went into the state Court and these respondents were again forced to defend themselves in a long tedious proceeding. Now they are asked to temporarily ignore that proceeding and go back to the bankruptcy Court to do it all over again. If

the petitioner fails here then presumably the state action will be again picked up.

If the state Court had jurisdiction in July, 1937, or March, 1938, it still has jurisdiction. Nothing has happened in the meantime to change that situation. For several months prior to the trial of the state action Chapter X of the Bankruptcy Act was on the books. If the passage of the Bankruptcy Statute superseded the state act concerning an action that was then pending it would have been a conclusive defense in the state Court, but that is not the case. The law seems to be well settled that where the proceeding is pending under a state act at or prior to the time of the passage of the Bankruptcy Statute, the state Court continues to have jurisdiction under a valid state act until that proceeding is finally determined. If that is the law, and it seems to be, then for the Bankruptcy Court to proceed in this proceeding means that two Courts in two separate jurisdictions are proceeding at the same time to occupy the same field in administering the same estate.

If it should be considered that both the District Court and the state Court had concurrent jurisdiction then the law is perfectly well settled that the moving party is put to his election as to which Court's jurisdiction he will invoke and the one first invoked has exclusive jurisdiction from then on. (15 C. J. 1131.) The situation that exists here, however, is not one of concurrent jurisdiction but one in which the federal Court had no jurisdiction over those matters that were pending in the state Court for a similar purpose at the time the Bankruptcy Act was passed. If the act under which the state Court is acting is constitutional, then clearly the state Court at Merced had and still has exclusive jurisdiction over the subject matter of this controversy. (R. 381.) This we now show.

A STATE PROCEEDING PENDING UNDER AN INSOLVENCY LAW OF THE STATE AT THE TIME OF THE PASSAGE OF A BANKRUPTCY ACT IS UNAFFECTED BY THE PASSAGE OF SUCH ACT.

The foregoing proposition seems to have been uniformly held to be the law. While there are not a great number of authorities on the point, one way or the other, after a considerable search we have found none denying the above proposition, but we find a number of authorities supporting it.

Several authorities are collected in a note in 45 L. R. A., at page 187, supporting the following statements of the author of that note, where he says:

> "Proceedings under State insolvency laws pending at the time of the passage of a bankrupt act are not affected by the latter act."

Mr. Justice Story is quoted from in the case of *Larrabee v. Talbott,* 5 Gill (Maryland) 426, 46 Amer. Dec. 637, as follows:

> "That as soon as the bankrupt act went into operation, in February, 1842, it ipso facto suspended all action on future cases, arising under the state insolvent law, where the insolvent persons were within the purview of the bankrupt act. I say future cases, because very different consideration would or might apply, where proceedings under any state insolvent laws were commenced, and were in progress before the bankrupt act went into operation * * *"

In *Martin v. Berry,* 37 Cal. 208, 211, the Court said:

> "If a State Court has acquired jurisdiction under a state law of a case in insolvency, and is engaged in settling the debts and distributing the assets of the insolvent before or at the date at which the Act of Congress upon the same subject takes effect, the State Court may, nevertheless, proceed with the case to its final conclusion, and its action in the matter will be as valid as if no law upon the subject had been

passed by Congress. This question arose in the case of Judd v. Ives, 4 Metcalf, 401, and was determined as just stated."

In *Minot v. Thacher,* 7 Metcalf (Mass.), 348, 41 Amer. Dec. 444, the Court said:

"The proceedings under the insolvent law having been instituted before the bankrupt act was enacted, they could not be superseded by the application, under the bankrupt law * * *"

In *Greenfield Bros. v. Brownell* (N. M. 1904), 76 Pac. 31, referring to Bankruptcy Act of 1898:

"* * * It was only intended to act in the future, and to take cognizance of such acts of bankruptcy as were committed after its passage. As to acts committed under its passage, there could be no collision between the bankrupt laws and the laws of this territory which we are now considering, because the bankrupt law was not, and could not under its express terms be operative as to acts committed before its passage. We can see no reason for not permitting an action brought under the territorial statutes to proceed, * * * Unless this construction is held, it is obvious that the bankruptcy law might act as a shield * * *" etc.

See also *Day v. Bardwell,* 97 Mass. 246, 255.

In re Bruss-Ritter Co., 90 Fed. 651, the Court had before it an involuntary bankruptcy proceeding under the act of 1898. That act provided for a certain day on which it would take effect, and also provided that involuntary proceedings could not be commenced within four months after that date. During that four months period an insolvency proceeding was commenced in the state Court. A motion was made to dismiss the bankruptcy proceeding on the ground that an action was pending in the state Court when the bankruptcy act took effect. The Court seems clearly to recognize the rule, but held that while

an involuntary proceeding could not be filed within that four months' period, still the act actually took effect at the earlier date and prior to the commencement of the action in the state Court. The Court necessarily denied the motion, but it was clearly indicated that had the state proceeding been pending prior to the effective date of the Bankruptcy Act or prior to its passage, then the motion would have been good.

In the nature of things this question would not often arise, but as above indicated, so far as we have been able to find, every time the question has arisen it has been decided as above indicated, namely, that when the proceeding under an insolvency act of the state is pending at the time of the passage of the Bankruptcy Act that proceeding is unaffected and the Court in which it is pending has jurisdiction to carry that proceeding on to conclusion. If that be the case then the federal Court does not have jurisdiction of the same matter at the same time. Since the United States Court does not seem to have jurisdiction while that jurisdiction is in the state Court, we suggest that this proceeding ought to be now ordered dismissed.

Quite apart from the foregoing, two further considerations must be kept in mind. The first is that the existence and effect of such a state law is anticipated and allowed for by the terms of Chap. IX providing that no decree of the Court shall interfere with the state's control of the political and governmental operation of its agencies; and second, the California Legislature in the enactment of Sec. 19 of the act seems to have undertaken to provide that in event of failure of any portion of the act or dismissal there should be in any case a validating and confirming of the contract of novation as between the district and accepting creditors.

NINTH PROPOSITION: IT IS RES JUDICATA BETWEEN THE PARTIES THAT THE CONSTITUTION FORBIDS THE GRANTING OF THE RELIEF SOUGHT.

Assignment of Error No. 4 reads:

"The cause is *res judicata.*"

For discussions of the proposition stated in the heading, we refer to the two separate briefs filed respectively by Mr. George Clark, and by Brobeck, Phleger & Harrison.

It is, we submit, there shown:

(a) That the rule of *res judicata* applies to issues of law as well as to issues of fact;

(b) That questions of constitutional law and questions of jurisdiction become *res judicata* between the parties just as other issues do;

(c) That the final determination of such questions is concluded once and for all between the parties, even though that determination is later departed from;

(d) That here, therefore, the determination, in the earlier case between the parties, that the Constitution forbids the granting of the relief here sought, is *res judicata* between the parties, and so determinative of this case.

TENTH PROPOSITION: CHAPTER IX OF THE BANKRUPTCY ACT IS VOID AS APPLIED TO APPELLANTS.

Assignment of Error No. 1 reads:

"Chapter IX of the Bankruptcy Act of the United States is unconstitutional and void and affects the property interests of the appellants in that it violates Article I, Section 10, Clause 1, of the Constitution of the United States and the Fifth, Tenth and Fourteenth amendments to the Constitution of the United States."

Assignment of Error No. 2 reads:

> "The State of California has not consented and cannot consent to these proceedings." (R. 283.)

The decision of the Supreme Court of the United States in *United States v. Bekins,* 304 U. S. 27, 58 S. Ct. Rep. 811, is not conclusion of the validity of Chapter IX of the Bankruptcy Act as applied in this case, for the reason that the *Bekins* case does not deal at all with several factors present in this case, which, we submit, render application of the statute to appellants herein unconstitutional.

(a) As here applied, the Bankruptcy Act prefers junior liens to senior liens, and discriminates among liens of equal rank.

The case of *Northern Pacific Ry. Co. v. Boyd,* 222 U. S. 482 (as elaborated in later decisions), establishes the following fundamental qualities that a plan of corporate organization must have to be binding on non-consenting creditors:

> (1) It must give precedence to the entire claims of creditors, including unsecured creditors, over any participation or interest of stockholders in the old company.
>
> (2) The entire amount of claims of a preferred class must have precedence over claims of subordinate classes.
>
> (3) The plan must not discriminate among the members of any one class of creditors.

The fourth syllabus in *Kansas City Terminal Ry. Co. v. Central Union Trust Co.,* 271 U. S. 445, reads in part as follows:

> "* * * a plan of reorganization of railroad company which does not give precedence to entire claim of unsecured creditors over any part or interest of stockholders in old company, is insufficient as to unsecured creditors, and not binding on them."

It is well settled that for a plan to be fair as between classes of creditors, it must satisfy their claims in the order of priority.

Louisville Trust Co. v. Louisville Ry. Co., 174 U. S. 674;

St. Louis-S. F. Ry. Co. v. McElvain, 253 F. 123;

Mountain States Power Co. v. Jordan Lumber Co., 293 F. 502.

In *Eagelson v. Pacific Timber Co.,* 270 Fed. 1008, the plan gave persons holding common stock share for share in the new company, but holders of common who also held preferred stock were not permitted to trade in their common until they had paid $10 in cash for each share of preferred, for which they received a new preferred share of $10 par value. The majority of common stockholders held common only. The dissenting minority held common and preferred in about equal amounts. The Court said at page 1110:

> "* * * The several holders of the common stock were, among themselves, denied equal rights of participation in the new company * * * as the holders of more than half of the common stock * * * had none, or practically no preferred stock, while many persons, including the plaintiff and the intervenors, held substantially equal amounts of preferred and common stock, it is manifest that the plan of reorganization was for the benefit of the majority to the detriment of the minority, and consequently unfair and fraudulent."

We respectfully submit that the principles referred to above are fundamental, and inherent in the idea of bankruptcy.

As applied to debts of governmental agencies, Section 80 inevitably violates each of them, as we now propose to show.

Much of the land within the Merced Irrigation District is subject to mortgages securing debts owing to banks and individuals. (R. 416, 420.)

In addition to being encumbered by the bonds of Merced Irrigation District, most of the lands in the district are burdened with bonds of one or more other public agencies. Wholly or partly within Merced Irrigation District are to be found five road districts, three high school districts, thirty-five grammar school districts, one mosquito district, three drainage districts, and three cities, all of which have outstanding bonds collectible by assessment upon lands in the respective districts mentioned. In addition, the county itself has outstanding a large amount of bonds. (R. 957-958.) Under the law of California the bonds of most of the foregoing public agencies are of equal rank.

LaMesa Irr. Dist. v. Hornbeck, 216 Cal. 730;
San Joaquin Irr. Dist. v. Neumiller, 2 Cal. (2d) 485.

The result therefore of the application of Chapter IX of the Bankruptcy Act to the petitioner is to prefer junior claims to senior claims, and to discriminate among claims of equal rank.

We submit that this result of the application of the Bankruptcy Act to the present case violates the due process and equal protection laws of the United States Constitution. We submit further that under the *Boyd* case and the other authorities cited above, Chapter IX thus applied is not a law "on the subject of bankruptcies" within the meaning of that provision in the United States Constitution, and is therefore not a statute authorized to be enacted by that instrument.

(b) The California statute purporting to consent to this proceeding is void under the Constitution of California.

As declared by the United States Supreme Court in the *Bekins* case, 304 U. S. 27, 58 S. Ct. Rep. 811, Chapter IX of the Bankruptcy Act cannot be applied to any public agency of a state unless the state in question has consented.

A statute purporting to consent has been passed by the legislature of the state. (*California Statutes,* 1939, Chapter 72.) We submit that the statute is void under the Constitution of California and the decisions of the Supreme Court of California.

Section 16 of Article I of the Constitution of California provides that "no * * * law impairing the obligation of contracts shall be passed".

This prohibition applies to contracts of the State or its subdivisions as well as private contracts.

Floyd v. Blanding, 54 Cal. 41;

Meyerfeld, Jr. v. So. San Joaquin Irr. Dist., 3 Cal. (2d) 409.

It is of course settled that a statute materially impairing the remedies for enforcement of a contract impairs its obligation within the meaning of the constitutional prohibition.

Welsh v. Cross, 146 Cal. 621;

Jeffreys v. Point Richmond Canal Co., 202 Cal. 290.

If the federal bankruptcy Court has jurisdiction to enforce the scaling down of debts here sought to be accomplished its final decree, of course, puts an end to the power of the state Courts (or indeed any Court) to enforce the remedies given by law to bondholders for the protection of their rights.

It follows that the operation of the California statute purporting to consent to proceedings under Chapter IX of the Bankruptcy Act not only impairs, but wholly destroys, the remedies given by the California laws for the enforcement of the bonds of appellants.

We know of no reason to suppose that the Supreme Court of California would depart from the decisions above cited concerning the scope and effect of the provisions of the California Constitution forbidding the impairment of the obligation of contracts. This Court, we therefore submit, should assume, until it has otherwise been held by the state Courts, that the purported consent statute passed by the Legislature of California is void under the Constitution of the state. This being true, Chapter IX cannot validly be applied against appellants in this proceeding.

(c) The State cannot surrender its sovereign powers.

Since the decision of the *Bekins* case by the Supreme Court of the United States, it has been definitely settled that California irrigation districts are agencies of the state, exercising purely governmental functions.

Anderson-Cottonwood Irr. Dist. v. Klukkert, 97 Cal. Dec. 348, 88 Pac. (2d) 685.

For the state to attempt to surrender control over the powers and activities of such an agency is to attempt to surrender its sovereignty, *pro tanto.* This cannot be done.

Pollard v. Hagan, 3 How. 212;

U. S. v. Constantine, 296 U. S. 287.

CONCLUSION.

We respectfully submit, for the reasons stated above and in the separate briefs filed on behalf of individual ap-

pellants, that the judgment of the Court below should be reversed with directions to dismiss the proceeding.

Notwithstanding the great difficulties necessarily confronting appellants in attempting to rebut the evidence adduced by petitioner on the merits, it clearly appears, we submit, that unless the petition herein is to be taken as proving itself, it is clear on several independent grounds that petitioner is not in need of the relief sought in the plan of which it seeks approval.

Dated, October 16, 1939.

Respectfully submitted,

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Florence Moore; American Trust Company as trustee under a certain agreement between R. S. Moore and American Trust Company dated December 15, 1927; Crocker First National Bank, as trustee under a certain agreement between Florence Moore and Crocker First Federal Trust Company, dated December 15, 1937.

W. COBURN COOK,
Attorney for Appellants,

Milo W. Bekins and Reed J. Bekins as trustees appointed by the Will of Martin Bekins, deceased; Milo W. Bekins and Reed J. Bekins as trustees appointed by the Will of Katherine Bekins, deceased; Reed J. Bekins; Cooley Butler; Chas. D. Bates; Lucretia B. Bates; Edna Bicknell Bagg; Nancy Bagg Eastman; Charles C. Bagg; Horace B. Cates; Barker T. Cates; Mary Edna Cates Rose; Mildred C. Stephens; N. O. Bowman; W. H. Heller, Fannie M. Dole; James Irvine; J. C. Titus; Sam J. Eva, William F. Booth Jr., George N. Keyston, George W. Pracy; H. T. Harper, and George B. Miller as trustees of Cogswell Polytechnical College; Tulocay Cemetery Association, a corporation; Percy Griffin; Emogene Cowles Griffin; D. Lyle Ghirardelli; A. M. Kidd; Grayson Dutton; Frances N.

Shanahan; Stephen H. Chapman; Edith O. Evans; J. Ofelth; Dante Muscio; I. M. Green; E. J. Greenhood; Julia Sunderland; Lily Sunderland; Florence S. Ray; Joseph S. Ray; Amelia Kingsbaker; S. Lachman Company, a corporation; Sue Lachman; Sophia Mackenzie; Nettie Mackenzie; R. J. McMullen; J. R. Mason; Gilbert Moody; William Payne; C. H. Pearsall; Alice B. Stein; Sherman Stevens; E. G. Soule; Margaret B. Thomas; Isabella Gillett and Effie Gillett Newton as executrices of the Estate of J. N. Gillett, deceased; Theo. F. Theime; Fletcher G. Flaherty; Frances V. Wheeler; Miriam H. Parker; Apphia Vance Morgan; First National Bank of Pomona; George F. Covell; Alma H. Woore; George Habenicht; Seth R. Talcott; Adolph Aspegren; J. H. Fine; Mrs. J. H. Fine; F. G. G. Harper; and W. S. Jewell.

(Appendix Follows.)

Appendix.

Appendix

SECTION 11 OF THE DISTRICTS SECURITIES COMMISSION ACT.

Sec. 11. Whenever any district has levied the annual assessment required by the laws of this State and when the money derived from said assessment, together with any other revenue allocated to payment of bond interest and principal, is insufficient to meet the bond interest or principal when due and said district defaults on its bond principal or interest, or both, to the extent of not less than twenty per cent (20%) of the amount due, said defaulting district may become subject to the section and to the control and direction of the commission as herein provided upon the application of such district and the approval thereof by the commission. Thereafter it shall continue subject to this section and to such control and direction during the effective period of this section unless and until the amount raised by its annual assessment as hereinafter provided, together with other revenue derived from any source and allocated to bond service or other outstanding obligations, shall be sufficient to meet and pay off all matured and uncanceled or unrefunded obligations of such district, bonded or otherwise, in which event it shall cease to be subject to this section and such control and direction shall terminate so long as said district does not again default as aforesaid. Upon receipt of written notice from any such district, the California Districts Securities Commission shall make such an investigation of the affairs of the district at the expense of the district as it may deem proper and for which funds are available in order to inform itself as to the financial affairs of the

district and its lands, and to enable it to carry out the provisions of this section intelligently.

The board of directors of any such defaulting district, in levying the annual assessment of the district, may, notwithstanding section 39 of the California Irrigation District Act or any other provision of law governing such district, levy only for such total amount as in their judgment by a finding of fact, approved by the commission it will be reasonably possible for the lands in said district, taken as a whole, to pay without exceeding a delinquency of fifteen per cent. In determining the amount it is possible for the lands to pay, at the time of each annual assessment, the board of directors shall consider the productivity of lands in the district, crops growing and to be grown during the year, market conditions as well as they can be forecast, the cost of producing and marketing crops, and obligations of the land respecting taxes and public liens. Out of the money derived from such annual assessment the board of directors of the district may set aside such sum as, in the judgment of said board, and approved by the commission, may be necessary, in addition to other revenue allocable to that purpose, for the operation and maintenance of said district and its works for the ensuing year. The balance of said money derived from such annual assessment shall be prorated to bond interest, bond principal and to other outstanding obligations of the district in the proportion that the total amount due on each of said items shall bear to the said balance.

Notwithstanding anything in this section contained, in any case in which an irrigation district has heretofore

defaulted or shall hereafter default in the payment of its indebtedness as in this act provided, no district shall be deemed to be or have been under the control or direction of the commission as in this section defined or under the supervision or control of the commission as to the fiscal affairs of such district until and unless the commission has or shall have made its order approving a reduced assessment.

This section shall remain in effect only until the first day of November, 1939, unless sooner repealed. The Legislature expressly declares that this section is intended to be applicable to all bonds, obligations and assessments of districts which have defaulted to the extent hereinbefore set forth, and the Legislature expressly declares that, except as otherwise expressly provided by law, it applies, and shall be considered to apply, to all bonds now or hereafter issued and outstanding. Nothing in this section contained, however, shall be deemed to extinguish or cancel any obligation due from any district, and whenever the annual assessment, levied as hereinbefore provided, leaves matured bond principal or interest or other matured obligations unpaid, said unpaid balance shall continue as a district obligation until paid or refunded in accordance with law.

Sec. 2. The agricultural emergency referred to in section 2 of Chapter 60 of the Statutes of 1933 continues to exist, and it is necessary for the same reasons that section 11 of the act cited in the title hereof was enacted to continue the section in effect until November, 1939.

Sec. 3. Nothing in this act contained shall be applicable to refunding bonds of any irrigation district issued under

or pursuant to a plan of readjustment submitted to and confirmed by any United States District Court in any proceedings under the Federal Bankruptcy Act, as amended, or any plan of readjustment submitted to and confirmed by any court of competent jurisdiction under any law of the State of California, and such refunding bonds shall be payable, as to both principal and interest, from assessments levied and collected in accordance with the terms of said bonds and the plan of readjustment pursuant to which the same are or are to be issued, anything in this act to the contrary notwithstanding. (Amended Stats. 1937 p. 491.)

This statute was originally enacted in 1931, providing relief similar to what it provides now. As quoted above, it became effective August 27, 1937. The present municipal bankruptcy act was passed August 16, 1937. (50 Stat. 654.) This proceeding was commenced June 17, 1938. (R. 8, 36.)

By amendment approved May 9, 1939, the California statute, as quoted above, was amended so as (a) to require a 50% default (instead of 20%) before invoking the statute originally, (b) to exclude from its purview all bonds issued after the date of the 1939 amendment, and (c) to extend the life of the statute to November 1, 1941.